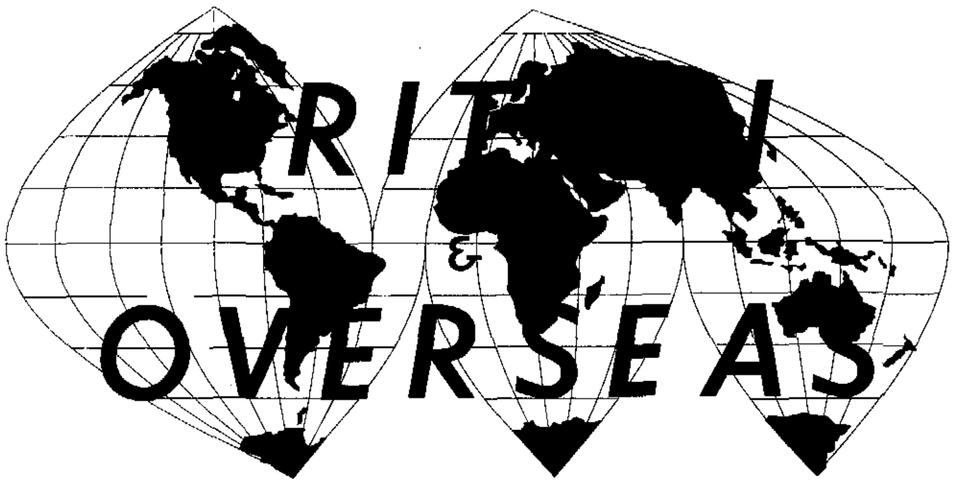


A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY
AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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# MONEY AND THE LAND MARKET

*Summary of a talk by Fred Harrison*, Director of the Centre for Incentive Taxation, to members of the Economic Research Council on Tuesday 28th January 1992*

THE RELATIONSHIP between the financial system and the land market ought to be central to current economic analysis; it isn't. I offer an account of why greater attention ought to be directed at the way we use and abuse land. Then I analyse a theory of growth, which focuses on the money supply, which was advanced by William Petty in the 17th century. Finally, I evaluate some policy implications, by highlighting the significance of Japan's response to the contemporary economic crisis.

## The Crash of '92

THE MARKET ECONOMIES are floundering. For two years, politicians have whistled in the wind to buoy up their spirits, but by the first quarter of 1992 both governments and independent commentators acknowledged that Britain and the USA were suffering the worst downturn since the Great Depression of the 1930s.

Few of the explanations can even pretend to account for downturns in geographically dispersed economies, the causes of which appear to be identical in their origins. The favourite scapegoat is the deregulation of the financial markets in the early 1980s. We are asked to believe that it was the ready availability of a variety of novel financial instruments which encouraged lax lending and thereby caused the boom/bust five or more years later.

The facile nature of this explanation is highlighted by the historical evidence. It is true that, without access to cash or credit, the profligate spending associated with booms would be difficult to undertake. And historically, we can point to economies whose financial systems were not regulated, and which experienced booms/slumps. The US in the 19th century is a case in point. Operating in 18 year cycles, in each case the land market reached a peak before turning down – dragging other sectors of the economy with it.

It could be argued that this illustrates how unregulated financial markets are associated with land booms/busts. But that does not prove a causal connection. It is not the same as saying that the deregulation under President Reagan and Prime Minister Thatcher was responsible for the boom/bust in the land markets during the 1980s, which then undermined the building sectors and, through the multiplier effect, contracted aggregate incomes which then undermined the building sectors and, through the multiplier effect, contracted aggregate incomes which reduced consumption – in turn

* The author is editor of *Land & Liberty*, a London-based magazine specialising in the economics and politics of natural resources. In 1987, Fred Harrison's analysis of the land market led to his prediction (which he published in January 1988) of the 1992 global economic crisis.

| U.S. Economy and Cycles | | |
|---|---|---|
| Land value peak | Building cycle peak | Economic recession |
| 1818 | - | 1819 |
| 1836 | 1836 | 1837 |
| 1854 | 1856 | 1857 |
| 1872 | 1871 | 1873 |
| 1890 | 1892 | 1893 |
| - | 1916 | 1918 |
| 1925 | 1927 | 1929 |

Source: Fred Harrison, *The Power in the Land*, London: Shepheard Walwyn Ltd. 1983, p. 65.

undermining demand for goods produced by manufacturers.

Note, for example, how those economies experienced an identical cycle in the late 1960s which terminated in 1973 – a period when the financial markets were closely regulated by the central banks. People who chose to speculate in the land market did so, without the benefit of those instruments which achieved popularity in the 1980s: options, swaps, forward rate agreements and the like.

In other words, the financial "deregulation" hypothesis is a scapegoat. It distracts policy-makers from what I consider to be the fatal flaw in the structure of the market economy; namely, the unique qualities of land, which – at certain points in time – enable speculators to undermine the wealth-creating process.

## The Petty Effect

SIR WILLIAM PETTY (1623-87) is called "the founder of political economy" for his pioneering work in relating statistics to economies. The results were embodied in his *Political Arithmetik* (1691).[1]

Economists have not yet plumbed all the riches in Petty's work; I will focus on one passage, on page 116. This relates to Petty's reflections on how to raise the level of economic activity – an issue which still challenges government today.

Petty argued that there were sufficient idle hands and the potential for employment to raise national income by £2m per annum. He advocated that under-used land should be sold, which would enable people to earn wages. But to whom should the land be sold?

1 *Political Arithmetic* was written in the 1670s but not published for 20 years, because the contents were thought to risk offending France.



Land, he argued, ought to be sold to foreigners:

"... selling of lands to Foreigners for Gold and Silver, would inlarge the Stock of the Kingdom: Whereas doing the same between one another, doth effect nothing. For he that turneth all his land into Mony, disposes himself for Trade; and he that parteth with his Mony for land, doth the contrary; But to sell land to Foreigners, increaseth both Mony and People, and consequently trade."

There were two critical weaknesses in Petty's recommendations, but before exploring these, consider some of the fruitful insights.

First, Petty identified a key cause of unemployment (one that was to be fully analysed two centuries later by Henry George, the American social reformer[2]). Idle land means idle hands. The equation is blindingly obvious, but one that is strenuously ignored by economists today. Second, buying land, *per se*, does nothing to enhance the productive process.

But Petty failed to understand the inflationary impact on the economy, as a result of increasing the supply of money by means other than the production of new wealth. By recommending that the domestic supply of money be increased by selling land to foreigners, he encouraged the creation of aggregate demand in excess of the capacity of the economy to supply goods and services.

Inevitable result: inflation. Too much money chasing too few goods – at least, in the short term.

The lesson: anyone seeking sustainable, non-inflationary growth needs a formula for expanding production in line with purchasing power. The land market provides a means for de-stabilising this process, for trade in land facilitates the expansion of the money supply without, of itself, encouraging the production of additional goods and services. Two contemporary examples illuminate this point.

- JAPAN. Vast amounts of money flowed into Japan during the 1980s. This was not due to the sale of land to foreigners, but to the efficient manufacture of goods for export. But as a result of tax-and-tenure policies, the Japanese were free to speculate in the land market. This caused an acceleration in the rise of the price of land way above other prices. This successfully distracted many people who might otherwise have devoted their creative energies to production.
- BRITAIN. UK financial institutions expanded the supply of credit to domestic borrowers without taking into account the consequences of speculation in the housing market. When families "trade up" in the residential sector, they are actually speculating in the prospect of future rises in the value of the land beneath their homes. This led to an expansion of the domestic money supply, which manifested itself in a boom – which had to result in a bust. Banks and building societies relied on land values as the collateral for the money which they advanced to borrowers: and the faster the rate of increase in land prices, the greater the willingness to expand the sum of loanable funds.

2 Progress and Poverty (1879): New York, Robert Schalkenbach Foundation, centenary edn., 1979.

We know, from history, that a land boom has to terminate in an economic bust; so it was in Britain (and the USA) in 1991/92; so it is in Japan, in 1992/3. This process, of course, had little to do with the deregulation of the money markets, but everything to do with the get-rich-quick psychology of land speculation!

### The Policy Implications

WE CAN now identify a second critical defect in William Petty's prescription that, to raise the levels of economic activity, land should be sold to foreigners.

The first round of land sales would not, of itself, necessarily result in the sites being put to productive use. In an inflationary regime, the safest repository of value is – land! What was to stop the foreigners holding the land idle, in expectation of further price rises, rather than making it available to those who could increase the supply of goods and services? By holding their sites idle, the owners (whose country of origin, as Petty suggests, is irrelevant) would be guaranteed a large capital gain.

Speculative dealing in land, then, imposes a blight on the economy which two centuries of industrial history has exposed as the root-cause of unemployment.

We now see the importance of the correct analysis of economic relationships – and especially the direction of the flow of power. So long as speculation in land is rewarded with higher profits than from any other form of activity (which is always the case during the run-up to the end of the classic 18-year cycle in land prices), the market economy will be subjected to interference with business activity.

What can we do about that unbridled power which corrupts the free market?

We can adopt the command economy. A Marxist system which took the means of production into social (which means bureaucratic) control, prevents individuals from speculating in land. Alternatively, we can develop a solution within the framework of the market economy.

The free market is the most efficient means for both allocating scarce resources and enabling consumers to express their preferences. How can we prevent land speculation without inhibiting enterprise?

In Britain, Margaret Thatcher's Chancellor, Nigel Lawson, "cooled" the economy by raising interest rates. That penalised everyone, including entrepreneurs and consumers who played no part in the land boom. By raising interest rates, there was certainly an effect on the land market: through the capitalisation process, a rise in interest rates reduces the selling price of land. But this solution also injures investors: they discover that the cost of borrowing money (which they need to finance the creation of new jobs) is pushed to unaffordable levels.

Alternatively, a democratic government could remove the financial benefits from those activities which skew the land market. That means a tax on the annual rental value of land. To be effective, the tax has to be so high (near enough 100%) that there is no point in hoarding the land which others wish to use.

The Japanese government's strategy in instructive. It realised that prices in the land market were pushed to unrealistic heights (characterising the process as the "bubble economy"), and it decided to take direct action. It introduced a tax on the value of land. The tax rate was low, but the influence was aimed directly at the cause of the problem.



BETWEEN the two extreme options – nationalisation of land, or socialisation of the rent of land – there is no effective intermediate solution.

Socialist governments employed second-best options in Britain in the years after 1947 (variations on both the land nationalisation and land taxation solutions); the experiments failed. And since we now know that the Marxist route leads to abject failure, it is transparently clear that reformers who wish to enhance the operations of the market economy have no option but to advocate land-value taxation (at a rate, alas, which has to be far higher than the one now in place in Japan, if the next cycle of destruction is to be avoided).

Unfortunately, current analysis is not enhancing the quality of debate in parliamentary chambers. Even the bankers are lending credence to the hypothesis that much of the current depression is due to deregulation of the money markets.

Take, for example, the defence of the changes in the British money markets by Brian Quinn, the Executive Director of the Bank of England.[3] While insisting that, on balance, the benefits must have exceeded the costs of deregulation, by implication Mr. Quinn appears to validate the deregulation hypothesis by justifying the response of the banks. The "credit crunch", he declared, was a natural response to "what have been characterised as the excesses of deregulation in the late 1980s". The Bank of England, then – it appears – does not challenge the analysis of what drove the UK economy into depression; but contents itself with the claim that "the surest – if most painful – way of inculcating more prudent behaviour amongst borrowers as well as lenders is to lose some part of the money which one has placed in the financial system."

People who make mistakes do need to pay the penalty: that is a condition of freedom (though the Bank of England's ambivalence on this scope is evidenced by Mr. Quinn's observation that "The Bank does not believe in capitalism red in tooth and claw"). But the pain of financial loss has been inflicted on innocent people, precisely because the analysts have failed to identify the cause of current travails.

There is an intimate relationship between land and money, but the overriding frictions stem from the tax-and-tenure arrangements, and not with a shortage (or abuse) of money.

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3 Address to the *Financial Times* conference on International Banking, February 25, 1992.

## THE ECONOMICS OF BOOK PUBLISHING

*Summary of a talk by Anthony Werner of Shepheard Walwyn publishers, to members of the Economic Research Council on Thursday 28th November 1991.*

### To Publish? At what Retail Price?

The publisher is a vital link in the chain between the author and the reader. The work of writing is a solitary occupation which results in a manuscript copy of the book – today, of course, the manuscript is typed or even produced on a word processor and there may be two or more copies, but it is the raw material with which the publisher starts. A publisher may initiate the idea for a book – say on making dolls houses, and commission someone to write it, or the author may have the idea himself/herself and approach a publisher with the idea or the finished manuscript.

This brings us to the first and most important function the publisher has to play: the decision to publish or not. In the case of a commissioned book that decision has already been made to some extent in advance, but the basic considerations remain the same. The publisher has to assess whether the work reads well, whether it communicates the subject clearly, whether it gives an accurate portrayal of the facts and whether there is a market for the book.

From the last question springs such a decision as whether to present the book as a hardback or paperback; is it a specialist book or a mass market book; should it be illustrated or not; what is the competition? From all these questions the form of the book emerges and its price.

The price of a book is, as always, a matter of balancing costs of production with what the market will bear. As a rough rule of thumb in publishing the cost of production will be multiplied by six to arrive at the published price. This may sound a very high mark-up, but we have to remember that publishing is governed by the Net Book Agreement of which so much has been heard recently.

The effect of the Net Book Agreement is that the publisher fixes the retail price below which the bookseller may not sell the book. Thus within the six times mark-up is not only the publisher's margin but also the bookseller's. Moreover, the author's share of the proceeds, usually about 10% of the published price, has to be met from the retail price.

The presentation of the book, i.e. whether it is hardback, paperback, illustrated or not, is determined by a combination of publishing tradition, subject matter and the size and price sensitivity of the market. Thus it is traditional for new books to come out in hardback, but that is changing as many people will not now buy hardback books.

The greatest influence on the price of a book is the number of copies printed initially. Thus, for example, for a specialist book where the total market is perhaps less than a thousand copies, all the cost of typesetting, printing and binding has to be recovered over a short print-run, but to the thousand potential customers, the material is of great importance. Academic treatises fall into this category and their main market is specialist



libraries. Such a book may be priced £30-50 a copy.

At the other extreme, and here I stray outside my own area of publishing, you have novels by popular authors, Dick Francis or Catherine Cookson, where the first print-run may be 40-50,000 in hardback, or 100,000 in paperback. In the former case the price is likely to be close to the minimum the publisher can charge to recover his cost of production, in the latter what the market will bear is likely to be the more important consideration, but huge advertising costs are usually associated with this type of book, whereas the advertising budget in the former case is small.

All these considerations are a matter of judgement by the publisher. If he gets them right, the firm will prosper, if not it will struggle or go down, pretty much like any other business.

### The Moral Aspect

But publishing can also be seen in another context. Just as bodies need food and drink to keep them going, so our minds need food and drink to stimulate our imagination, to increase our knowledge, understanding and appreciation of things. This is the cultural aspect of publishing. Just as we have become increasingly aware of the effect of junk food on our bodies, so it is important to realise that we can all too easily these days fill our minds with junk and this will affect the way we behave. Here the publisher has a responsibility to society, though not all publishers would accept this. Some feel that the only criterion for what should be published is whether it will make money or not.

I heard an amusing story about one of the editors of a tabloid paper with page 3 girls who enquired anxiously of a colleague whether a particular beach to which he proposed to take his wife and children was topless or not!

### And Economic Realities

Publishing is both labour and capital intensive. A great deal of work goes into producing a book. The author, for example, may have spent twenty or more years acquiring all the information and evaluating it. The publisher's editor has to read and evaluate the manuscript, and then proof-read the copy when it comes back from the printer to ensure accuracy. There is all the attention paid to design, advertising, and marketing one book, not to mention sales and warehousing, perhaps only to achieve a sale of 1000 copies.

Fortunately, from the point of view of keeping costs down, there is an over-supply of labour to the publishing market, so that wages generally are low, though even lower in bookselling. In fact when it is appreciated how much work goes into producing a book, it will be found they represent surprisingly good value for money, especially if you compare the price of a book with a meal in a good restaurant or a theatre ticket – and you can read and reread the books many times if you wish.

As I mentioned, publishing is also capital intensive because books cannot be printed a few at a time to satisfy current demand. The publisher has to estimate the likely total demand for a book – if this is very large, he can print sufficient for the first six months or so, but for the majority of books the first printing will take years to sell out, tying up working capital in the meantime. This is why so many publishing companies have been bought up by capital-rich conglomerates in recent years, but the conglomerates soon find out that while publishing is glamorous, it can lose them a lot of money and so they cut back.

The publisher is essentially an entrepreneur. He brings together the author who has researched and written the book, the printer and binder who manufacture the physical object, the sales and marketing people who sell and market the book to the public through bookshops and libraries, and the finance. This last can be provided by shareholders, bank loans (but this is risky in view of the long term investment often required), or by selling on some rights in the book to other publishers, for example selling foreign language rights or North American rights. This is, of course, not only a way of funding the book, but of laying off some of the risk.

### The Future

This has necessarily been a wide-ranging talk because publishing touches on so many aspects. New electronic media have emerged to compete with the book as a means of communicating information and providing leisure, but I think the book will endure. It is a very convenient medium, portable, durable and easy to dip into for reference – you need no other power supply than the God-given ones of hands and eyes.

## THERE COULD HAVE BEEN ANOTHER WAY IF ...

*By David Bell*

During the Autumn of 1988 interest rates were nearly doubled – to 13%, a policy which marked the onset of the current disastrous recession. The economy had been allowed to drift rudderlessly upwards and was then hammered down ruthlessly with all the ensuing costs of reduced investments, reduced employment and repossession of private houses. And the main casualties were Britain's strong political leadership – and Margaret Thatcher.

With the benefit of hindsight one can now see that earlier action – a small increase in interest rates, a small increase in VAT and an inflation adjusting reduction in the value of sterling during 1987, would have most likely averted the 1988-89 balance of payments crisis, moderated capital expenditure in housing, and allowed the vigorous economic performance of the mid-1980s to continue.

The question is, why didn't the then Chancellor, Nigel Lawson, take such action in 1987/88?

An objective reading of events suggests a curious explanation, namely the 'trivial' matter of the size of uncertainties in financial statistics. For example, the current account balances of the Balance of Payments for 1986 and 1987 which *ought* to have alerted the Chancellor in 1987 and 1988 to the need for early action on interest rates, taxes and the exchange rate, were coupled with "errors and omissions" as follows:-

| | $bn | | | |
|---|---|---|---|---|
| **Year** | **1984** | **1985** | **1986** | **1987** |
| Balance of Current A/C | 2.3 | 4.1 | 0.2 | -7.0 |
| Errors & Omissions | 7.4 | 6.4 | 21.1 | 5.6 |

With several occasions when the figure for errors and omissions had been greater than that for the balance itself the Chancellor was fully entitled in preparing his March 1988 Budget, to ignore the estimated deficit for 1987.[1] Thus although many economists and the opposition in Parliament were calling for a lower exchange rate, their advice went unheeded and the deficit was covered by international borrowing. (Even so, it is hard to dispute the logic for a modest devaluation at that point given the fact that the internal value of the pound had been reduced by about a quarter of the 'underlying' rate of inflation since 1979 and the inadequacy of the UK machine tools and capital goods industry which did not increase output between 1970 and 1980 – a time when such countries as the USA and Italy showed increases around 40%.)

The minus 7 billion dollar estimated deficit on the current account for 1987 shows its true significance once it is placed in the context of the two following years.

| | $bn | | | |
|---|---|---|---|---|
| **Year** | **1986** | **1987** | **1988** | **1989** |
| Balance of Current Account | 0.2 | -7.2 | -27.7 | -32.6 |

Note: by 1990 the deficit for 1987 had been revised upwards from $7.0bn to $7.2bn

These figures were published in November 1991 in the IMF's *International Financial Statistics* based on CSO publications and the *Bank of England Quarterly Bulletin*. The 1987 figure was to be a mere prelude for the drastic plunge in 1988.

If the Chancellor's first error was to mistake the significance of the current account balance for 1986 and 1987, his second was to assume that the increase in imports during 1987 and 1988 was due to a consumer spending spree fuelled by credit. In fact the major part of both credit increase and import increase during those years went to business expansion and capital goods imports. The figures *now* available tell against the hypothesis that consumer spending was the main or sole cause of the rise in imports in three respects:

1 During a Lords debate on The Quality of Government Statistics, 13th March 1991, it was suggested that the CSO had suffered from staff cuts which followed the Rayner review of the Civil Service. The CSO has been revising some of its past figures since transfer from the Cabinet Office to the Treasury in 1990.

1. It is inconceivable that there should be a consumer spending spree without an increase in the use of credit cards. Yet the quarterly figures for credit-card borrowing show the same pattern in 1988 as in previous years – level in quarters 2 and 3, up in Q4 (Christmas) and down in Q1 of the following year (repayments) and show no significant change in amounts.
2. The 'Personal Sector' as defined by the CSO includes unincorporated businesses as well as individuals; and the former will cover most start-up and very small businesses. CSO *Financial Statistics* for the years 1987 to 1990 only give two figures of loans to the Personal Sector: Table 7.5 shows the total of bank loans to the Personal Sector of less than £15,000 each while Table 9.3 shows the total of all banking and credit card lending separately. By subtraction one finds the total of bank lending to the Personal sector in amounts of more than £15,000 per loan. These larger loans are more likely to have been for industrial or commercial use than for private household expenditure and these increased more in 1988.
3. At least 30% of imports, and possibly up to 70%, are destined for industry. But it must be remembered that raw materials and semi-finished goods are imported by industry on the basis of their anticipation of selling finished goods to consumers. In the broad classification of imports and exports in Table 15.1 of CSO *Monthly Digest of Statistics* one can at least assume that 'capital manufactures' are for factory investment and 'other consumer goods' for purchase by consumers. Both show an increase in 1988 over 1987, but the peak in July of each year was up 28% for capital goods compared with 22% for consumer goods. The reason for a peak in July is not clear. In 1988 the base rate of interest of retail banks was at its lowest, 7.5%, from 18th May to 3rd June so it might be thought that delays between placing of orders and arrival of goods might cause orders placed in the second half of May to result in July imports; but in 1987 there was no obvious reason for a similar (but less pronounced) rise. Although interest rates were increased in steps from 7.5% at 2nd June to 13% at the end of 1988, imports continued to grow.

In a recent 'Any Questions' programme on Radio 4 one of the participants likened faith in raising interest rates to the medieval faith in a magic mushroom which could cure all ills. Presumably the idea was that raising interest rates would make consumer credit more expensive and so reduce the spending on imports by consumers. It now appears that raising interest rates was not effective in reducing imports until they had first reduced economic activity generally and caused unemployment – now an irreversible process within ERM membership.

The process has multiple consequences. Many of the bank loans to businesses in 1987 and 1988 are now the bank's bad debts and it has meant the disruption of the lives of entrepreneurs whose business plans invalidated – to say nothing of the employees who lost their jobs. One can only feel desperately sorry for those who happened to enter the housing market in 1987 and 1988 only to face repossession today. Furthermore, housing costs which include mortgage payments are included in the retail price index and so raising interest rates fuelled inflation not only by raising the costs of working capital but by encouraging higher wage claims. And anyway factories face higher unit costs through working at less capacity in the 'recession'. Thus, the main rise in inflation came *after* the rise in interest rates showing clearly which was cause and which effect.

Surely there could have been another way if the figures from the Central Statistical Office had been less erratic?



## IN THE SHADOW OF A GIANT

*An Editorial from the Japan Times, Tokyo*

Death this week claimed one of the finest thinkers of the 20th century. Among the great minds of our age, few have been as productive or as influential as Professor Friedrich August von Hayek, the Austrian-born British economist and political philosopher who died at 92 on Monday in Germany. Through his long life he became, like Sigmund Freud, a whole climate of opinion.

The comparison with Freud, another Viennese, is not idle. Hayek was one more of those towering geniuses that the Austrian capital loosed on the contemporary world. The close-knit intellectual hothouse of Vienna before and after World War I (1914-18) brought three formidable generations of thinkers into vibrant contact.

The result was a revolution that has transformed the way the world understands itself. The honor roll of talent is extraordinary: the generation of Ernst March and Gustav Mahler yielded in the 1910s to that of Freud, Arnold Schoenberg and Ludwig Wittgenstein (Hayek's distant cousin and British philosopher Bertrand Russell's student, who is regarded today as this century's greatest philosopher). The result has been successive Viennese schools of music, art history, economics and philosophy. Peter Drucker, the influential management thinker, is one of the last great living heirs of this diaspora of Viennese talent.

Hayek was a giant even among this formidable company. Certainly he is so regarded in Britain and the United States, where he taught after 1931. His insistence that no conscious human agency or bureaucracy could master the amounts of information necessary to the successful working of vast modern economies formed a cardinal assumption of the neoconservative revolutions of Reaganism and Thatcherism.

Indeed it is Hayek, despite his ever-shifting interests and positions, who rightly deserves the title of "father of monetarism", and not Professor Milton Friedman. This may explain the view often heard in centers of learning here and in Europe that Mr. Friedman derived most of his ideas from Hayek's work.

True, there has been a recent resurgence in the influence of Hayek's great British rival, John Maynard Keynes. But where free markets are identified with freedom from tyranny, Hayek casts an enormous shadow. It is no accident that, while the Hungarian communist philosopher Georg Lukacs may have provided the intellectual ballast for the Gorbachev revolution, the ideas of Hayek are proving to be indispensable to rebuilding post-Communist East Europe. There the ideas of the author of the 1944 classic, "The Road to Serfdom", point the way to the road from serfdom.

No one should be surprised therefore that this modern master has left his mark on Japanese academic thought and policy practice. His works have been studied here, often with intensity and admiration. But Hayek's importance to this part of Asia is to be found not in what he says about Japan but rather in what he has encouraged others to expect of Japan.

Hayek helped to redefine the meaning of the term "conservative". A socialist in his early years, he became one of socialism's most effective critics. He encouraged Western political conservatives to replace religion and tradition with a secular creed of individualism and free markets.

One result is that when Japanese trade negotiators sat down with their Western colleagues during he contentious 1980s, they often say opposite the intellectual children of Hayek. It was the Austrian embrace of Adam Smith that has helped to give American and British trade policymakers their enlightened edge and ideological punch.

The Bush administration's slow, painful surrender to managed trade has been made slower and more painful because of the coherence and intellectual respectability that thinkers such as Hayek – and none has been greater than he – have conferred on free-trade doctrine. It is because of economists such as Hayek that much Japanese public policy, including this country's much-debated industrial policy, is sometimes derided both here and abroad as "irrational".

For an East Asian to grapple with Hayek is to encounter another universe of political and economic assumption. He leaves a great intellectual challenge. As the "Asian Century" takes shape, this region's encounter with postmodernity will determine what is living and what is dead in the thought of this great economist.



## "THE MONETARIST GOLDEN AGE"

*By Geoffrey W. Gardiner*

Samuel Brittan wrote an article in the Financial Times of the 24th February 1992 under the heading "UK monetarist golden age – alas a myth." He was commenting on articles by Professor Patrick Minford and Tim Congdon, the first of whom appears to have lauded the praises of M0 as an economic indicator whereas the latter preferred M4. Malise Graham kindly asked if I would like to comment.

My first point is that all money is debt. To use T.B. Haran's excellent terminology, with regard to all money there is always both a "debtor party" and a "creditor party". Money that is used as a medium of exchange can be defined as "assignable debt". All financial assets are debts in one form or another. Some debt is intermediated by banks (widely defined) and that constitutes very roughly what economists call M4, "the broad money supply". Non-intermediated debt is bonds and shares and direct lendings, and any other financial security that the market cares to invent.

The *combined* level of intermediated and non-intermediated credit is what is important for the growth of the economy and/or inflation. Any consideration of a single element of the credit supply on its own is misleading. The use of any single element as a definitive economic indicator is intellectually unsound and bound to be unreliable.

Money being debt is created whenever a debt is created by a lending institution. When a debt is funded the level of the intermediated credit supply goes down and that of the non-intermediated credit supply goes up.

The maximum level of the intermediated supply of credit is determined by the capital base of the lending institutions. This point has become academically respectable as from January this year for Professor David Llewellyn, who was present at the ERC meeting in January 1990 when I advocated this view, has published an article in the January 1992 issue of Bankers World and in it he states that principal. Llewellyn's article is of enormous significance.

It follows therefore that the creation of "money" can only take place when the banks have the requisite capital ratio (shortly to be made uniform worldwide in accordance with the Basel Convention). Funding of debt frees part of the banks' capital base thus making it possible for them to create further credit. Moreover banks will always want to make full use of their capital bases and therefore whenever funding takes place they will endeavour to create more credit, if they can find takers, in order to replace what they have lost, and so that they make the fullest possible use of their capital base. Their return on shareholders' capital is crucially dependent on this being done and it also affects their competitiveness on interest rates.

Earlier monetarists were under the illusion that funding reduced the money supply and even advocated "overfunding" by the government in order to reduce the money supply! When the overfunding policy was applied from 1980 to 1984 the theorists[1]

1 See page 232 of Professor Charles Goodhart's book "Money, Information and Uncertainty".

could not understand why it was accompanied by an explosion of lending to the personal sector and a continued growth of M3! The reason was elementary: the banks could not lend to the government so they stimulated the demand for credit by the personal sector.

As money is created by the granting of credit we should be talking about the "credit supply", not the money supply. It follows that the statistics for M4 are wrong in principle for they measure the level of *deposits*, not the level of *credit*. Some of the lendings of banks are funded by the banks' own capital so the credit figures are always bigger than the deposit figures. When totting up the lendings one should include the assets of both the Banking and the Issue Departments of the Bank of England. As the assets that back M0 are much the same as those of any bank M0 is irrelevant when one looks at the assets side of the balance sheet.

The liabilities side of the balance sheets of the banks reflects money that could be spent by the owners of the deposits; the assets side reflects money that has been spent. Both are important.

One can have instances (Keynes quotes one in the "Treatise") when the effect of a growth of bank credit is negatived by a reduction in new issues and consequently economic activity or prices reduce. This demonstrates that the two basic divisions of the credit supply, intermediated and non-intermediated, are *both* important and a monetary theory that concentrates on one alone is defective. Moreover a huge part of the intermediated credit supply is used to provide liquidity to the bond market, thus ensuring that financial resources that are represented by bonds can have a frequency of circulation. Indeed turnover on the Stock Market divided by M4 is a greater figure than GDP divided by M4.

The idea that the growth of M0 is a significant economic indicator has always seemed to me to be somewhat foolish. It is just as likely to be an indicator of the crime rate, the level of tax fiddling, the growth of drug peddling, and the rise of the black economy! Currency is the preferred medium of exchange and the medium for storing wealth by those engaged in all those activities. The last time I looked at the statistics I noticed that M0 amounted to £275 for every man woman and child. I do not carry £275. Who does? Did not the invention of credit cards substantially reduce the demand for currency and thus make the progress of M0 difficult to interpret? I will give some credit to the importance of M0 when someone can tell me who precisely holds these enormous sums of cash. US dollar M0 must nowadays be inflated by the fact that dollar bills are the preferred currency in the CIS!

When high real interest rates will hold back or stimulate recovery depends on many environmental factors. There are instances of both phenomena.

I believe that there is evidence that in Britain high nominal interest rates tend to cause inflation. There are plenty of theoretical grounds for expecting that to happen and perhaps most significant is the increase in costs. The difference between the highest and lowest Bank Rates in the last 70 years is 13%. If that rate is applied to the level of M4 as at 31.12.1990 one gets a figure roughly equivalent to 11.4% of GDP. Adding in the increase (regrettably impossible to calculate) in payments of interest on the non-intermediated credit supply and the total increase in costs is horrendous.



## THE EDWARD HOLLOWAY COLLECTION REVIEW

*Analysis of Usury by Jeffrey Mark*
*Published by Dent, London 1935*

The Economic Research Council began life in the early 1930s as the Economic Reform Club. One of its first tasks was to form a members' library the contents of which were to reflect interest in what was perceived as the main problem of the time – the paradox of poverty and unemployment co-existing with idle factories, excess production and an apparent surplus of savings. It was a time for both sober analysis as well as for fanciful conspiracy theory. The library of the Economic Reform Club richly reflected this contrast – with Jeffrey Mark's contribution sitting very firmly in the latter category.

This delightfully written, beguiling, 128 page book subtitled "With Proposals for the Abolition of Debt", has two sections headed *Bondage* and *Freedom*. The first speaks of control, exploitation, usury, unearned income, debt and depressions – and war. The second talks of abolishing debt and rent and the need for 'absolute economic security'. All this under a preface about Christianity, socialism and monetary reform. One approaches the book therefore with stratospheric expectations.

Now there *are* very real Christian, liberal and free market concerns with usury, monetary practice and the banking system. The Pharisees and money changers with their harsh laws and exploitation Christ dealt with in no uncertain manner; liberals in the tradition of Adam Smith's 'Theory of Moral Sentiments' have always been concerned with the pre-eminence of ethical considerations over unreasonable contract – hardly siding with Shylock in *The Merchant of Venice*; and supporters of free markets worry over monopolistic abuse anywhere – including the banking industry. The 1930s, with the *gold* standard, with an excess of bond holders (a legacy of W.W.1 finance) and with widespread awareness of financial abuse and mismanagement, were a time when proposals for serious reform stood a good chance of winning political credence. Certain established interests and privileges were in obvious danger!

Now in any reactionary movement there is a role for the spoiler in the enemy camp, for the advocate who exaggerates and simplifies a cause to make it easy for his real friends to ridicule that cause. Geoffrey Mark seems to have carried off this role magnificently. Claiming sympathy for the poor and a devotion to an idealistic world he proposes economic reforms which seem superficially so reasonable but which are economic nonsense – false flags on a friendly mast.

He begins by defining usury as the charging of interest on money lent: any interest whatsoever, be it to governments, banks or individuals. The rest of us understand usury to refer to excessively high interest charges. But let us continue. He argues that all money is credit created by private banks and that interest can only be paid if the banks put the community into extra debt to pay this interest. The rest of us know that money as cash or credit circulates so that a given amount can be paid, repaid, paid, repaid and paid again in one time period enabling, in theory, very large interest payments to be made without an increase in the outstanding volume of money. He brings in a moral argument that it is 'brainless' to suggest that savers should have an interest rate reward for consumption foregone. The rest of us understand that whilst on occasion savings might outweigh investment opportunities thus justifying nil interest returns, this is not a normal or happy circumstance.

Mark borrows freely from the *Social Credit* movement to advocate the issue of money exclusively by the government, free of interest, to ordinary citizens. The rest of us are entitled to ask just how this is to be rationed and how the government is to choose the more worthwhile investments. He then goes further and advocates that the state or community should properly bear the cost of 'any depreciation in value whether due to obsolescence or any other cause' – i.e. taxpayers should shoulder the burden of all bad debts! Turning to land he 'is of the opinion that it ought to be in the absolute possession of the state'. The rest of us know the difference between site value taxation and land nationalisation.

To complete this wonderland, Mark would absolutely guarantee everyone's job, allow the government to determine wages and free industry from 'barbarous competition' – all notions which can only amount to Soviet-style nationalisation, state monopoly planning and Communism.

And all this to get us away from the gold-wielding conspiracy of finance, emanating from the meetings of the Bank of International Settlements in Basel. Pah! More insulting yet, he calls upon the Catholic Church and the names of "men who honour the name of democracy" listing Blake, Burns, Beethoven (Beethoven?), Tom Paine, Cobbett, Jefferson, Jackson and Lincoln, to support his proposals.

So far as this reviewer is aware, the name of Jeffrey Mark has been forgotten. And rightly so.

J.B.

## ASPECTS OF JAPAN

***The Japanese Economy by Takatoshi Ito***
*MIT Press 1992*

Without doubt this is a major work – a factual textbook written and published in the style of Samuelson's *Economics*, it has succeeded in presenting the right depth and coverage to qualify both as an introductory work and a reference manual. Any serious student or commentator on the Japanese economic scene would benefit from it. When the expensive hard back edition – price £48 – is followed by a cheaper paperback, it will surely be widely used.

The section headings indicate the scope:- Historical background, Economic Growth, Business Cycles and Economic Policies, Financial Markets and Public Finance lead on to Industrial Structure and Policy, The Labour Market, Saving and the Cost of Capital,



International Trade and Finance. Finally under "Contemporary Topics", Trade Conflicts, the Distribution System and Asset Prices. It covers, in other words, all that a textbook should cover and constantly give sources for alternative views.

In current circumstances such a book is by no means easy to construct. So much has been published which is either unrealistically flattering or mischievously critical that the student may well conclude that only personal study in Japan can give him a true picture and a balanced view. Ito cannot, in one work, solve this problem but he has certainly gone a very long way in helping the student sift wheat and straw and approach the subject in a balanced confident manner.

I would criticise the book in minor ways though. Most of the comparisons are to America which may be a little offputting to the non-American reader. Sometimes major points are summarily stated, especially those critical of Japan, whilst 'pro-Japanese' counter arguments are given fuller treatment. One wonders quite what is the point of noting that Japanese school-children work "more hours per week and more weeks per year" when their shorter working day at school – compared to the West – is not mentioned. And somewhere behind the exposition there lies a touch of "tatemae" inevitably discernable with any Japanese author. Japan's economy is in so many ways a 'rip off' of the consumer, the worker and the shareholder. Restrictive practices abound from ordinary sales to 'Sokaiya' activities to rigged bidding on construction contracts. Such things tend to be either not mentioned or glossed over. For this the student must look elsewhere.

All the same, the chapters on such aspects as savings and international trade represent impressive summaries; the chapter on the Japanese distribution system is notable for its amazing conclusion "The Japanese distribution system is as efficient as its US counterpart" (p. 404) and the final section of equity prices displays delightful inconclusiveness.

***Japan as – Anything But – Number One by Jon Woronoff***
*Published by Macmillan, December 1991*

This is the ideal book to complement "The Japanese Economy" by Takatoshi Ito. Here Woronoff draws together the strands, experiences and knowledge gained during authorship of at least 6 previous works on Japan and it does so in the context of the main claims made on behalf of Japan by such enthusiastic writers as Ezra Vogel and Edwin Reischauer.

It is significant that Woronoff claims to be a 'Japan realist' rather than a 'Japan basher'. The distinction is an important one and is, I feel, justified by the text which leads one through the maze of facts and observations with a refreshing willingness to award sensible comparative grades for each of the topics listed.

Woronoff is ready to accept the idea of Japan as number one in certain limited aspects – in, for example, the lay-out, efficiency and cleanness of many modern factories. But in many areas such as education and policies he finds Japan only at best on a par with many other countries and 'inferior grades' are accorded to working hours, the standard of living and housing.

"Yes", he says "sometimes we can learn from Japan" but he shows convincingly that those who give Japan excessive praise all too often mislead us. He has done a great service in balancing their excesses.

### *Life in Japan – A Poetic Footnote*

"Life in Japan" is rather like being on board a large ship – perhaps a large cargo vessel that also carries a good many passengers ...

To start with the sea rocks the ship about now and then – earthquakes set the scene.

The buildings are more ships than houses – basically a steel frame with pipes and tubes, wires and windows. The grey metal of the office furniture is, for all the world, the inside of the Navy, and each building has a heavy keel and can sway in a tempest.

Then life itself. One lives in accommodation which is more like the cabin of a ship than a natural house – small, efficient, warm and expensive.

And the people? Hierarchical, efficient, busy, polite and mostly slightly distanced. One either 'belongs' or one does not. And who would one find on board our ship? Well, the crew to start with – the workers and students of Japan who each know their place and each function like a trained team. Then one would find the passengers – of various classes. There would be 3rd class passengers to start with – these, in Japan, are the drop-outs and poor elderly. Then there would be the main 'ordinary' class passengers – in Japan the housewives without jobs, the respectably retired, the foreigners with pseudo jobs. And then there are the first class passengers – the Yakuza, the politicians ... and foreign researchers on decent grants.

And a concensus of businessmen is the captain – but then no ship is a democracy. Now there are also stowaways from Iran, the Philippines ...

So we look over the rail at the sea, out of the portholes through the newspapers and half wish for, half dread, the end of the voyage and the return to normal life.

J.B.



## LETTERS

### *A response to Policies for Recovery* by Lord Vinson from Dr Bernard Juby.

Sir,
I rise to the challenge of Lord Vinson's statement ("Policies for Recovery" B&O, Winter 1991) that, "The concept of two-tier interest rates is unworkable, ..."

We already have a multi-tier taxation system for both income and VAT, to say nothing of National Insurance Contribution rates and Corporation Tax. There is also a multiplicity of rates available for investors and borrowers via the money-lenders.

The time has long since passed when we should distinguish between borrowing for investment directly in businesses and jobs (and recognising the long-term commitment that that entails) and borrowing for short-term consumer consumption.

Yours etc.,
Dr Bernard Juby – Policy Unit
Federation of Small Businesses
140 Lower Marsh
Westminster Bridge
London
SE1 7AE

### *A response to Japan: The Hara-kiri Economy* by Brian Reading from Mr Ron Read.

Dear Sir,
In the context of Brian Reading's excellent and fascinating paper on the Japanese economy I would suggest that outside of the socio-political matters referred to, which we assume may be solved with will, the kernel of that country's long term economic problems is its lack of natural capital.

Variations on the title of a 60's TV comedy "Never Mind the Quality Feel the Width", which would seem to sum up the asset full United States, may be apposite. "Never Mind the Width Feel the Quality" seems appropriate to our own island, while "Little Quality or Width" seems relevant to a Japan which has only the natural talents of its now static population with which to earn a living.

In a Japan without public altruism, too much more (from savings, and from wealth earned abroad) invested internally, exploiting the few resources available for other than industrial investment, can only push up the Yen capital values of, and, if a stable society and currency is to be maintained by controls, reduce the monetary yields from, the assets that are developed. Indeed, given that profitable outside markets continue to exist, more industrial development would mean more wealth. A prosperous Japan must buy assets abroad if increasing income is not to be negated by falling yields and asset inflation at home.

The comparison with Britain is instructive. Britain, built on coal, surrounded by gas, fish and oil, with some of the finest agricultural land in the world, elements of many minerals and a temperate climate, our little island, once the world's leading industrial power, is asset rich: what went wrong? Indications are, too much altruism. A book could be written on the cause and effect of the misguided policies of successive governments, short termism, a lack of understanding of the true capital value of technical knowledge, the cancellation of major technical projects to build public sector houses that weren't needed: an investment market distorted by rent control. It is little acknowledged at the moment that a major contributory factor to the current house price slump is the availability, for the first time since the war, of a viable rented alternative to purchase. The concept that mergers were right – any who still believe that should check how many manufacturers of cars, cameras or electrical goods there are competing within the Japanese economy! Those sectors in the UK have been decimated by the application of unproven economic theory.

Thus Britain, which started with great natural advantages has chosen to dissipate its capital wealth, in mirror image to Japan.

Ron Read
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**A response to letters from Mr Selby, Mr de Mare and Dr Artingstall from Mr T.B. Haran**

Sir

It would appear from the letters of Mr Selby, Mr de Mare and Dr Artingstall in the Autumn 1991 edition that there is still no understanding of the true nature of money. As it is essential to get this right, here is a further example.

In a primitive society, a farmer asks a labourer to dig some ditches over several weeks in return for food. The labourer cannot start until the following week, but the food supply is commenced immediately.

An obligation has arisen between them. It is bilateral – a credit *in services* of the farmer and a debt *in services* of the labourer. That is the true nature of "money".

On completion of the transaction, the credit and the debt disappear, so the money has



been destroyed. Money is *not* a "stock", which must be held, and instead is subject to a process of continuous creation and destruction.

A book-keeper agrees to keep a weekly account of the transaction. He values a week's performance of both services at 5 units, credits this sum to the farmer and debits it to the labourer.

Alter the example. The book-keeper becomes a banker and lets the labourer draw a cheque for 5 units; the labourer gives it to the farmer for the first week's food supply; the farmer pays it into the bank. Nothing has changed! The banker's figures are the same as the book-keeper's! Money is *not* created by bank lending.

Now let the loan be made in cash, which follows the route taken by the cheque. The same figures appear in the bank's books. Money is *not* created by the printing press.

The process by which money is created and destroyed takes place quite independently of any accounting procedure, banking system or note issue. Consider this point carefully, for it is of vital importance.

The situation has been the same since primitive man first traded with his neighbour. Indeed, it cannot be changed, no matter how sophisticated our settlement procedures and systems become.

Human beings, whether their work is productive or otherwise, can only perform and exchange services. The farmer had to convert his services into a food supply, so goods are actually the earliest form of media of exchange. As for wealth, it is simply a very valuable by-product of the system. Only changes placed on the values of services can, therefore, cause inflation or deflation.

As a concession to Mr Selby, I shall use "money" here in its accepted sense and refer to the underlying values in services as "basic money". Remember, however, that basic money is the real version and that media of exchange are simply temporary titles to it.

Each individual or group (firm, company etc.) is either a net creditor party like the farmer or a net debtor like the labourer. The effects of transactions on basic money supply, i.e. the status rules, are in brief as follows:

a) Creditor spending on creditor services – no change. (The spender destroys old basic credits, while the performer creates new basic credits to the same extent.)
b) Debtor spending on debtor services – no change. (The spender creates new basic debts, while the performer destroys old basic debts to the same extent.)
c) Debtor spending on creditor services – an increase. (The spender creates a new basic debts, while the performer creates new basic credits to the same extent.)
d) Creditor spending on debtor services – a reduction. (The spender destroys old basic credits, while the performer destroys old basic debts to the same extent.)

Total credits always equal total debts! Moreover, it is impossible to devise a transaction, which defeats the status rules.

As you know, a considerable part of my book is devoted to destroying arguments which purport to prove that banks create credit, and hence money, by lending. Now, I am accused by Mr de Mare of ignoring a theory, which I have shown in several ways to be completely wrong. He should be relieved to discover that the only power bankers acquire is the right to sit in judgement of borrowing propositions.

He is quite wrong in believing that industry creates no money of any sort. The main suppliers of goods and services are debtor parties in terms of services, which *reflects* in their bank indebtedness. They spend themselves into debt, just as the labourer did in obtaining food on credit. That is the very process by which basic money is created.

Really, Mr de Mare should have paid more attention to my letter in the Summer 1991 edition. The company in question faces the problem of how to settle the debts in services due to its workers for the services they have rendered to it. After all, three examples were given of how this could be done.

Perhaps now he will be able to understand my contention that bank-notes are not money itself (basic money), but titles to it. Moreover, he might realise that the issues have been confused by false monetary theory and not by my assertions.

Dr Artingstall is in error in believing that bankers do not re-lend their depositors' money. They act as middlemen and link the demand for borrowing to the supply of deposits. The effect is that it is the depositors, who, however indirectly or unwittingly, make the loans available to the borrowers. If the banks did not carry out this function, would-be borrowers would have to approach the depositors directly. His case is, therefore, based on a false premiss and, however well argued, has inevitably ended in unsound conclusions. No book-keeping system can alter the facts; it can only reflect or misrepresent them.

Clearly, Mr Selby is looking for the benefits to be derived from my thesis. Well, it really is a major breakthrough, for it can now be proved that inflation is not a monetary problem and that it lies solely with pay and prices. Consider an example.

Ineffective monetary measures did not prevent inflation arising and should not be credited with causing the subsequent falls in its rate. The economy has followed its own course and the recession was the inevitable result of business and industry increasing production, pay and prices beyond the limits the economy could bear.

Three groups could have prevented the recession, (1) employers (2) the banks and (3) the government.

1) When the recession began employers chose to dump surplus employees onto the labour market. Yet, they could instead have cut all remuneration and kept up the level of business by taking the saving from prices.
2) Inflation has a weakness; it has to be financed. Consequently, many pay increases require additional bank borrowing. Thus, the employers concerned do not pay them from their own resources. Prudent banks should, therefore, provide finance for additional business, but not for pay increases. One might, of course, feel that the Bank of England, as the regulatory authority, should have issued instructions along these lines.
3) The government could eliminate inflation overnight. All it has to do is, by law, to cut all forms of remuneration and oblige employers to take the resulting saving in costs from prices.

Since inflation can be cured and prevented by any of the foregoing remedies or variants



of them, it cannot be a monetary problem. Mr Selby might like to note that the remedies "tip the scales in favour of the buyers" in the market-place.

Why is the pay and price level (PPL) so important? Because the outstanding credits lose or gain purchasing power to conform with the new ones being created. In like manner, debts become less or more burdensome to the same extent. Thus, increases and decreases in the PPL are the cause respectively of inflation and deflation.

Inflation continuously erodes the working capital of the nation and the position has been exacerbated by financial losses in industry, banking, insurance, etc. The first step necessary to get out of the recession is to rebuild the working capital, as otherwise increased investment cannot be financed. The market forces may take years, if ever, to do this, so the correct and quick remedy is to cut pay and prices. True, this action increases the burden on existing borrowers, who have been benefiting from inflation, but, more importantly, it prices the unemployed back into jobs and permits a higher level of business activity.

Every nation can generate its own basic money, and hence its own prosperity, by correctly managing its PPL. We are not, therefore, dependent on the German or any other economy. Moreover, interest rates, exchange rates and all the other variables are simply reflections of the state of the economy and are not levers by which it can be manipulated. There is, therefore, no alternative.

My methods are not those used by economists, nor are my concepts based on theirs. That, incidentally, is why there is no bibliography in my book.

By the way, whatever happened to all the professors who were on the right track in advocating incomes policy, but mistakenly recommended a package of monetary measures to accompany it?

Yours faithfully
T.B. Haran
"Grianan"
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