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

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CAN WE ACHIEVE FULL EMPLOYMENT?

A talk given by Bryan Gould M.P. to members of the Economic Research Council on Tuesday 23rd March 1993

Brian Gould began by pointing out that the British economy had, for many years now, become "profoundly uncompetitive", resulting in a narrowing manufacturing base and a large degree of unused resources (of which unemployment is merely the most visible statistic) and a balance of payments deterioration. In contrast, a truly competitive economy, he said, is something we have not known for a very long time. When, he asked, have we been able to take a green field site in this country and find conditions competitive with those abroad? He continued ...

There are various indices which try to measure our relative competitiveness. For example, one range of indices measure, or purport to measure, unit labour costs. There are all sorts of attempts made to measure these on a common basis. They are relative, and they are normalised, and all sorts of things happen to them to try and establish a common statistical basis, but essentially that index measures unit labour costs across the whole of the economy, whereas what matters if you are comparing us as a declining, shrinking economy with an economy which is moving out into export markets, you find that an economy which is expanding in that sense, has a very different cost structure for its expanding export industry than it does for its domestic production. Japan, for example, for most of the post-war period, has had a domestic inflation rate not a million miles away from the average, even from our rather poor performance. But if you look at export industries, then their cost structure is very, very different indeed. And therefore, any index which purports to measure unit labour costs across the whole of the economy simply misses the point.

Now I labour those points, briefly I hope, simply to make the point that we really do not bother, we virtually never bother to look at the evidence, and yet if we survey our economic history over a long period we can see the unmistakable evidence, the decline in our share of world trade, our narrowing manufacturing base, our declining living standards, and the national wealth by comparison with many other countries. We are now probably overtaken by Italy. We are in the course of being overtaken perhaps by Spain.

These are painful facts, which we choose not to confront and we concentrate on the here and now, and we very rarely stop to think about what has happened to this economy over the long period. By the long period I mean perhaps 100 years or more. Now why is it that we have suffered, at least in comparative terms, such an economic decline? I would argue – and this is purely shorthand for a number of other factors – I would argue that it is because we have concentrated over a long period on the short-term rather than the long, and that is a familiar charge made against our economic management, and I want to try and substantiate it by looking at some of the facts which I think have led us to do precisely that; some of the factors which have led us into a state of constant or almost constant economic decline in comparative terms over a long period.

Let me try and identify some of those factors. First I think we have been in this country preoccupied with a long debate between people I will call bankers on the one hand, and people I will call politicians or democrats on the other hand, as to who should control economic policies. The bankers always say that they must control the essential questions of economic policy because the politicians cannot be trusted – they will always debauch the currency – and the politicians say that if the bankers have their way they will always deflate, they will always rigidly adhere to policies of financial orthodoxy and they will create recession and falling output and unemployment.

Now, we have been susceptible to that argument perhaps more than others because we virtually invented the banking industry and the argument has raged for perhaps 200 years – I was reading today the report of the Select Committee on the high price of gold bullion in 1810, and amongst others I also read the 1886 report of the Select Committee on the depression of trade and industry, and the same arguments crop up time and time again, and you might say that the arguments are about rather esoteric things like the quantity of money, and when the bankers prevail – as they very often did on that question – they were privately so appalled at what that would mean for the economy that they then arrogated to themselves a monopoly over the creation of credit so that we could escape the problems of so severely limiting the supply of money.

But the point I make is that the bankers by and large in Britain have prevailed; that they have in one way or another, with rather few exceptions – always ensured that it is their view of the economy, their interests, which have prevailed; their interests are always those of the short-term rather than the longer term interest in investing in future wealth creation. So that is the first factor – I think an excessive dominance by bankers over our economic policy.

But that was exacerbated in our particular case by another factor. We became in the 19th century as the world's most successful industrial economy, an economy which was rich in assets. We had assets all around the world. We became preoccupied by the value of those assets, by the extent to which we could rely on an income from those assets to pay our way in the world. We ceased to be very interested in terms of making and selling things competitively into international markets because our assets actually provided us with protected markets anyway. We had our great armed forces to patrol the world to protect the assets. We developed in the City of London a great international market place where those assets could be traded, and as a consequence of all that we began to believe that what mattered above all else in economic policy was the value and stability of those assets, and the interests of those who held them, and we forgot, we simply lost the habit of running the economy in the interests of people who make and sell things.

And I believe that that hang over from our Imperial past still dominates our economic policy, but we don't realise it. I speak as somebody who came as a young man to this country – returning to the country of my forebears, but nevertheless coming with fresh eyes – and I like to think that I can see perhaps these things rather more clearly than people who have been brought up in the context in which everybody accepts it as absolutely normal that on questions of interest rates or exchange rates, it should be the Bank of England – a bank – which is listened to, whereas the CBI – poor, puny, pathetic voice that it is of what remains in British industry – the CBI is swept aside when it says that it wants perhaps lower interest rates or occasionally a more competitive path.

And then I would argue that in modern times we have exacerbated again, with compounding these errors by a mis-reading of our own economic history, and Mrs Thatcher I think quite rightly decided in the late 1970s that we couldn't go on as we were – that the post-war consensus which was designed to reconcile us to a comfortable decline should really be brought to an end. But unfortunately I believe she looked back – she and her advisors looked back – to a period in the 19th century when we were pre-eminent industrially and drew exactly the wrong lessons from that because what she said was that we did terribly well when entrepreneurs were free to do their own thing, no government around to stop them. Of course that was true. When we were pioneering, no-one had done it before, of course it was individual enterprise which pushed back the boundaries and achieved it, and it was the individual interests which then created the industrial revolution and industrial success. But what we overlooked was that other countries realised in the later part of the 19th century that they had fallen behind. There was a gap they had to make up. And how did they choose to make up that gap? Not by withdrawing government and letting entrepreneurs get on with it without any support or help. No, they said that the way to make up the gap is to use the power of government to help industrialists to identify targets, to work towards these targets, and that is what they did; and they caught up with us and overtook us, and it is now we who have to make up the gap.

And yet we believe or believed that we could make up that gap by reverting to a position which worked for us when we were pioneers, but was certainly exactly the wrong recipe for trying to achieve some sort of gain on countries which are now well ahead of us.

Now there, if you like, is an attack on what has been done by a right wing government, but I assure you I am no more sparing of my colleagues on the left, because whereas you might have expected the Labour Party to provide a powerful critique of all that I have described, the Labour Party developed a remarkable blind spot on all of these questions. The Labour Party – an industrial party in its origins – was preoccupied with the question of who owned and who controlled industry, the public ownership of industry was the important thing. We seemed unaware of the fact that the economy was not being run in the interests of industry at all, it was being run in the interests of finance.

I recall the statement of Winston Churchill when he became Chancellor of the Exchequer in 1925. He said, 'I would rather that industry was more content and finance less proud'. That didn't stop him from going on to the gold standard, but nevertheless, the sentiment was right, but we in the Labour Party didn't see that, and right through the whole period of Ramsay MacDonald's adherence to the gold standard and Harold Wilson's defence of the pound sterling, and Dennis Healey's conversion to monetarism, throughout that whole period the Labour Party, far from providing a powerful critique of the endemic mistakes of British economic policy, was actually even more susceptible to many of those mistakes, even than our opponents on the right. And it reached such a point in the late 1980s, so lacking in confidence were the Labour Party by that point, that we said almost in terms to the British electorate, 'Look, we know you don't trust us to run the economy, but in the end you don't have to trust us with running the economy because if you elect us we propose to contract out the whole business of running the economy to a wonderful thing called the ERM. So you needn't worry about us, the ERM will take responsibility for everything. They will assure us of a low inflation rate, you needn't worry about us being spendthrift or anything like that, because the ERM, run by those wonderful chaps in the Bundesbank, will ensure that there is no backsliding'.

And we are still at it. Even after the 16th September, the Labour Party still says that economic and monetary union and the single currency as provided for by the Maastricht Treaty are the guarantees that we need to ensure economic success.

Now I was one of those who argued, albeit within the secrecy of the Shadow Cabinet Room, that the ERM was likely to be a disaster. The reason – I take no particular praise because it was common sense – was that if you decree that your exchange rate, your currency is worth a certain amount, without reference to the actual purpose of your economy, the chances are that you get a block. Given the constant British predilection for always holding the exchange rate at the highest possible level whatever the interests of the real economy, the chances were that you were going to overvalue your exchange rate. This is duly what we did. No peep or squeak of difficulty or opposition from the Labour Party when that was done! We supported the June 1995 rate, but the result of that was that we immediately penalised all British production and we subsidised all production from elsewhere, so British industry began to hurt because it couldn't sell, and we then began to see that there was a bit of pressure on the exchange rate. People began to say that if the British government was mad enough to offer us 2.95 Marks for a pound, we will jolly well sell them the pounds and take the Marks, thank you very much. And so we found that we were having to take some additional measures to support the exchange rate and those additional measures were high interest rates so as to induce people to hold on to their pounds and earn the high interest rates. And we also cut public spending and investment in an attempt to show how serious we were; we would deflate the economy in an attempt to drive costs down in order to support the overvalued exchange rate, and of course what most of us didn't understand was that if you pushed up interest rates and cut demand and investment, you are actually adding to the burdens of British industry and so gradually and inexorably over a period, the gap between what you said your exchange rate was worth and what the performance of your economy actually delivered as your economy was enfeebled by the measures you took, that gap became wider and wider and wider, and in the end it could not be supported any longer. And that is what happened on 16th September and yet we now propose to repeat that experience in such a way as to provide no escape. The exchange rate mechanism could at least be allowed to fail, painfully and ignominiously, but at least there was an escape. If we sign up for the Maastricht Treaty, there will be no escape. We will suffer all the same consequences, but those wicked foreign exchange markets will no longer exist, which is like smashing the thermometer in order to cure your fever. We will therefore suffer all the consequences of falling output and rising unemployment, and social division, and all of that, but there will be no escape.

Now I don't want to make a speech about the Maastricht Treaty. What I want to do instead is to ask how we could do things differently. How do we escape from this constant predilection over such a long period for always giving priority to the money

economy, to the short term, to the interests of asset holders, to the interests of people who are already wealthy, rather than to the interests of people who want to invest to create wealth in the future.

Incidentally, let me just take two aspects of economic policy which are constantly misrepresented. We are constantly told by the present government and its predecessors that a policy of high interest rates and defending the pound is a matter of financial prudence. Nothing could be further from the truth. Show me an economy that suffers over a long period from high interest rates, and I will show you an economy which gives priority to the interests of those who hold wealth already rather than to those who want to invest money for future wealth creation. And show me an economy which always goes for the highest possible value for its money, and I will show you a country and a government which is always trying to squeeze in the short term a higher standard of living than we are entitled to, owing to the fact that our currency is overvalued, but pays a terrible price as a consequence by destroying the productive capacity of our economy for the future.

Now how do we escape these consequences? I think – maybe there are people in this room who perhaps have a sneaking sympathy with the analysis so far, they may not be so supportive of the prescription, I think we must now restore macro economic policy to its proper role. We are rather in the position of the national Government which came after the gold standard in the 1930s except that this time we don't have a Keynes to show us quite how to respond. Instead we have a government which is running around like a headless chicken with a policy forced upon it, which it neither understands nor sympathises with. What we had to do, it seems to me, is to give up the notion that the only thing that macro policy can do is establish conditions of monetary stability. Once that is established, you might as well choose as the argument has it, zero inflation rather than some other figure because it doesn't matter as long as it is stable – let us go for zero inflation, then government withdraws and everything is then running. I say that is not the way the economy works and that is not the true responsibility of government. Governments' responsibility as Keynes would have it, is to manage demand, have a view on the exchange rate, and a view on interest rates, have a view on what level of public spending is appropriate to a given situation. The macro economic policy that I would like is something that government must decide from virtually one month to the next in the light of the conditions of the economy then prevailing.

For example, today what I think is required is first of all an assurance to British industry that the relatively competitive level (it is not competitive enough because we never look at the evidence, but let us assume that it is at least an improvement on August 1995), the level of the pound will at least be maintained for the foreseeable future. No ERM, no taking advantage of the upward pressure of the market. What British businessman worth his/her salt would actually invest today on the basis of today's exchange rate, when we have the Governor of the Bank of England visibly supported by the Chancellor saying that at the first opportunity we are going to push the pound up? No-one would do that, and yet that is what is required. If we want to take advantage of the current level of the pound, we have to give an assurance that that is roughly where it will stay over a period, and we should also give an assurance that interest rates will be commensurate with that policy, in other words, kept low and indeed lower than they are at present. And if we are not satisfied – as I personally am not, and this can vary – if we are not satisfied that those factors alone will provide the stimulus required to get the economy moving again, then instead of cutting public spending, I believe we should be increasing public spending, increasing it for particular purposes, in particular ways, directed to investment and infrastructure and so on, and if we are worried about how to finance that (it may be right to be worried, I don't know, certainly I think it would be wrong to try and finance it through taxing people) there is an argument as to whether this increased borrowing would or would not crowd out investment and the supply of money for other purposes.

If we are worried about that, why not – deeply unfashionable though it is – create a little public sector credit through underfunding the deficit, or monetising the debt, or even (dare I say it?) printing a bit of money? Of course that is a silly thing to do in many circumstances. If you are up against your resource capacity, the last thing you would do is artificially increase the money supply in that way, it would be very dangerous to your inflation targets. That is not our problem right now, and what I am arguing for is a macro policy that looks at where we are at any given moment and I think there is a very strong case for that sort of measure right now, but if you were to tell me that in 6/9/12/15 months' time something quite different would be required, I would be very inclined to agree with you. As soon as we saw the economy moving and money sloshing around again, then we would have to take very different measures, but my argument is that we must restore, as I said, macro policy to its proper function. And then if we get that right, if we understand what we are trying to achieve through macro policy, then I think that some of the things which my front bench colleagues in the Labour Party are arguing for, could well be extremely valuable.

No-one is denying that we should be investing more in training and education, research and development, straightforward manufacturing investment and so on, of course that is absolutely desirable. There is no point in arguing for it or even taking measures to support it if your macro context is undermining everything you are trying to do, and in any case, even if it were wildly successful, it might produce results 5 or 10 years down the track, but it is hardly a solution to our immediate problems. Let us do it in conjunction with what we are trying to establish on the macro side, and let us also take some specific measures to try and deal with the short termism which affects all our decisions. Let us look at competition law which has produced, and it is not so bad at the moment because of the recession, but on occasion has produced an absolute mania for mergers and takeovers so that no director worth his salt is free from looking over his shoulder all the time, as to whether the cash flow and the performance in the short term quarter is good enough to ward off some contested bid from somewhere unexpected. Let us perhaps reverse the burden of proof. Let us make it rather more difficult to go for that sort of asset stripping and takeovers. Let us look at the accounting conventions which at present mean that any Board of Directors mad enough to spend money on training its personnel gets no credit for that in the Balance Sheet, no asset saying "Well trained work force". All that happens is that you spend money which reduces your liquidity and makes you look a bit more vulnerable to takeovers.

Why don't we look at those conventions to see if we can't produce a more sensible result. Why don't we do something which Lord Vincent and I have been discussing over dinner – why don't we recognise the overriding importance as a source of investment capital, of pension funds. Why not make them a real force for sensible investment rather than something that we all contribute to but have not the faintest idea as to what is happening to our money, and there is no-one in this room, I guarantee you (with the possible exception of Lord Vincent himself), I bet most of us have contributed to occupational pensions; for most of us it will be the second most important asset we ever have in our lives, and yet not one of us will know tonight how much it is worth, where it is, who has decided on where it should go. It is just something we hand over to some faceless people in the City who make decisions on our behalf, and I think we can get a more sensible view of investment if we were to change in relatively marginal ways the law about pensions and pension funds.

And here let me also make a plea which perhaps will be resisted by some of you – I believe that if there were one thing that we could do to improve the way in which industry is financed, it would be to reduce our dependence on equity financing and to develop a system of industrial backing. And we have said this for many, many years. The private banking sector has had every opportunity to develop just such a facility and if in the end they won't do it, then I think there is a powerful case for the public sector to do it in their place. That is what has happened in most successful European economies. It is the public sector by and large which has provided for industrial banking.

Now, these are just specific ideas which I believe could help to turn around the emphasis on short termism, to start to build a mentality which looks to wealth creation over a longer period, which gets away from the constant preoccupation with the money economy and asset holders and the short term.

I sum all this up by saying that we should re-establish full employment as the major objective of economic policy. There is no-one I think in the end who would argue against full employment, but there are perhaps many who say, well it is perhaps an unrealistic objective. We heard the same arguments in the 1920s and 1930s. We had a debate in the House of Commons about a fortnight ago, I heard speeches from the opposing benches which could have been delivered in the 1930s bemoaning and agreeing that it was a tragedy that there should be such a level of unemployment, but saying in the end you know there is nothing we can do about it. Yet the reality is that full unemployment can be achieved if we make our economy competitive, and we can make our economy competitive by stripping away some of the illusions and preoccupations which have so disfigured our economic policy for such a long period.

It may be that full employment is going to be difficult to achieve, but it is not impossible, and it is technically not difficult to ensure that you make full use of your resources. What you have to do is take a clear-eyed view of just how competitive you are, what you can expect people to pay for the goods you produce, and if you do that, then I think you can begin to work towards full employment.

There is no single measure that would contribute more both to social justice and to economic efficiency than to be able to use all our resources productively. I have recently set up (just within the last couple of weeks) something called the Full Employment Forum. It is not meant to produce miracles; it is meant simply to bring together the views and proposals of those who agree with me that we can and should set full employment again at the centre of our economic and political agenda, and I think that provided we understand the nature of the mistakes we have made over such a long period, which are so endemic that their very consequence have become inextricably linked with the mistakes themselves, so we cannot any longer disentangle them. If we understand that, and we make a conscious effort to break free from it, then we can again look to the real possibility of full employment.

BRYAN GOULD ON THE UK ECONOMY

By W.A.P. Manser

Bryan Gould's speech at the ERC dinner on the 23rd March was a brilliant performance in true top politician's style: fluent, persuasive, and bristling with points of incipient controversy. The following will take up some of the challenges implicitly thrown out.

One main theme of his speech appeared to be that Britain is wrong to rely on 'overseas assets' rather than on manufacturing exports. Although he disclaimed any party political purpose, this is nonetheless recognisable as a piece of hoary Socialist philosophy: the view that foreign income makes Britain an international 'rentier', and that the only products worth selling to the world are those of horny-handed industrial output – "if it doesn't hurt when you drop it on your foot, it isn't an export".

This goes in hand with a legend of equal antiquity: that until some fairly recent time – "within the last 100 years" he said – the UK ran a handsome surplus on merchandise trade. Modern economic statisticians have shown, beyond dispute, that this was not so, and was never so.

Britain has run a deficit on visible, or merchandise trade, throughout the whole of its economic life: certainly back to 1696 when trade statistics began, and, if one reads the commentaries of such as Sir Thomas Mun in the 1660s, and Hakluyt in the 1580s, clearly back to Britain's first emergence on the international trading scene.

Why does the belief in a golden era of export surpluses still haunt the minds of such as Bryan Gould? The answer is a fascinating story, too long to be told here in detail. It is a history in two parts: that of the longest statistical error in history; and that of the thrilling – if such a word can be applied to the dismal science – detective work of a group of economists in the early part of this century. The statistical error was that, from the beginning, the values of imports and exports were so miscalculated that they grossly exaggerated the latter, and sharply understated the former, thus producing an impressive trade surplus. Around the middle 1850s the discrepancy became too obvious to be overlooked; the Board of Trade corrected the method of recording; a visible deficit

promptly emerged, to continue until this day. The crucial point is that the Board of Trade thought it had remedied a mistake of its own day; *it did not realise that the error had been in existence for at least a century and a half.* Hence the notion that in its lusty youth the British economy triumphantly sold more than it bought, and that in the mid-nineteenth century – "about a hundred years ago" – it lurched into senescence and deficit.

Revelation of the standing deficit was the work of an international group of economists – Schlote, the Schumpeters, Imlah, Maizels, Clark, Cole, Deane and others – who by diligent examination and analysis of the data, traced their error back to its origin. Even then, the publication of their findings found little echo outside academic life. It was not until The Committee on Invisible Exports published a ground-breaking report in 1968 that the truth was recognised by Government and the official statisticians; albeit in low key, for it was a rebuttal of almost everything government had said in living memory. The myth of a glorious export past lingers in the British folk memory.

So how, if merchandise was in steady imbalance, was the deficit offset? It clearly was, or Britain would have been bankrupted centuries ago. The deficit was offset by the "overseas assets" Gould deplored; but not in the form of 'rentier' remittances that he imagines. We are not talking of dividends from Aunt Agatha's bequest in Nice. The inward flows were, and are, the incomes first, of the service industries – banking, insurance, shipping, aviation, securities dealing, commodity broking and many kindred activities, all producing fees, commissions and royalties; and, second, the profits and interest arising from overseas investment, part in bonds and shares held abroad, but chiefly in the subsidiary companies installed on foreign soil by British parents in industry, agriculture and the services. These incomes are, obviously, far from newly invested: they have been there from the start of British overseas activity. No-one who has read "The Merchant of Venice" or any part of our social history can fail to see the abundant clues to these unceasing flows of wealth into the country, and the concrete proof is in the statistical evidence extracted by the scholars mentioned above.

A moment's reflection will show that this was an inevitable development of the British economy. We have had only three indigenous raw materials in the whole of our economic history: wool, which disappeared nearly two centuries ago; coal, the viable life of which is now expiring; and oil, which emerged only thirty years ago, and will be gone in another thirty. Where else would a sensible nation put a significant part of its production, if not overseas where the raw materials are? More than this, we are a small island, densely populated, with a high general level of education, and access to the open seas: necessarily we developed the skills that go into the intangible activities of banking, insurance and the like, and we sell these abroad through our maritime connections. These, again, foster investment, and investment further nurtures the sale of services. Thus have British external payments and receipts balanced over the centuries.

No great stretch of the imagination is required to realise that, with the same geophysical and demographic characteristics, the other countries of Western Europe have matched the British economic pattern, as examination of their balance of payments records will show. All other Western European countries, that is to say, except for the odd man out, Germany. Her divergence is the product of an unhappy history. Up to the

First World War, Germany was no different from her neighbours. That War stripped her of all overseas assets and connections, and plunged her into economic and political ruin culminating in the Second World War. After that War, still denuded of foreign wealth, she nonetheless recovered. She did so by entrenching herself in her home industrial capacity, and directing, as she had to, a massive part of that output into exports. The world was duly awed by the ensuing enormous visible surplus, for in the popular mind a visible surplus is a totem of economic strength. Nobody noticed, or cared, that the enormous visible surplus was balanced by an equally enormous invisible deficit. Although admired as a prosperous country, Germany remained in fact not noticeably better off than her neighbours. With a strong Mark, induced by an admiring foreign exchange market, reinforcing a national aversion to inflation, she was thrifty, restrained and stable; but remained cartelised, old fashioned and provincial. No one deserts the fleshpots of Rome, Paris, Florence, or even London for those of Bonn or Wurzburg – although long ago they did.

Gould however went on to assert that the British obsession as he saw it, with 'overseas assets' had sponsored a decline in home manufacturing. A neglect, he declared, brought about by "the bankers, who control the economy"; this was vintage stuff – we have not heard of the bankers' ramp since the 1930s. (I will leave out of the discussion his curious interpretation of the credit mechanism as a tool of banker's greed). Mr Gould appears to have lost from sight the fact that, at 21% of GDP, the share of manufacturing in the British economy is virtually the same as for all other advanced countries. As national economies develop, the supply of material goods moves from new creation to replacement and refinement, in the course of which the need for services grows quickly. One does not add to the stock of refrigerators; one replaces them with new, more sophisticated models. One does not add to the number of computers; one devises new software. We are not building new ports, but we are equipping the ones we have with more flexible transport, more refined organisation, and with electronic communication. All these refinements come from the research and skills of the service industries. Thus, while manufacturing does not shrink in real terms (in 1991 British manufacturing was 23% higher than in 1981), services grow faster and take a larger share in GDP.

Mr Gould deplores the recent emergence of a deficit in manufacturing trade. Here he might well re-read the Corn Laws debate. In the last analysis international trade is the exchange of one currency for another. If you want other people to buy from you, you must buy from them; otherwise they do not have enough of your currency to pay for your goods. In the last decade we have added a major new item – oil – to our exports. Somewhere we must import more: we have done so in manufacturing goods. Mr Gould need not fear: when the oil surplus goes, so will the deficit.

Finally, Mr. Gould put his finger, rightly, on a real British weakness, and one that also contributes to the manufacturing deficit – although his explanation for it is fanciful. British economic performance has been poor compared with her rivals, and she has lost her share of world trade. Mr Gould puts this down, again, to the bankers' ramp. Significantly, he brushes aside, as somehow unrepresentative, a telling clue: the fact that UK unit labour costs (i.e., the manpower cost of producing a given amount of

goods) are, and have long been, higher than those of our competitors.

Nobody outside these islands has any doubt that the British have brought their ills on themselves by overpaying themselves, pricing themselves out of the world market and impoverishing their economy. With our own plethora of money supply, credit growth, exchange and interest rate theories, we have overlooked this basic cause of inflation. Captive as we still are to the Keynesian demand view of the economy, we are oblivious of the fact that a root cause of high prices is cost.

Here we have a piece of primary economic principle to relearn. All costs are ultimately labour costs. Nothing in this world has value until touched by human hand. There is no price label on a coal seam – 'This seam £20 per foot'. The coal has no value until a miner's hand has prised it loose; the machinery the miner uses has been fashioned by factory workers, out of metal smelted by workers from ore dug out of the ground by other miners. The foremen who lead the coalminers, the managers and directors who organise production, finance, and sales, the men who designed the mine and the mining machinery, are all human costs. As for mining, so for all industrial and service activity. Thus, everything 'made in Britain', depends for its ultimate price on the cost of British labour. Not everything we use in Britain has been made here: raw materials and finished goods reach us from abroad – totalling about 30% of all we consume. But the same rule applies: everything made abroad depends ultimately for its price on human labour. Thus all prices are determined by labour costs.

This explains why the Treasury forecasts, which get practically everything else wrong, are nearly always right about inflation, and why private forecasters are equally accurate. For the calculation is dramatically simple: any tyro economist can do it. All you have to do is take the increase in average UK pay, adjust it for the increase, or decrease, in output, take 70% of it to match it to the proportion that UK-origin costs are to total costs; then take the average cost of imports, and allow 30% of that: apply the time-lags for these costs to work their way through into the shops, and you can predict inflation in a future period – and you will be right.

So there you have inflation. The broad river of costs, which flows into prices, is a river of labour costs; and all the demand, credit, exchange rate and monetary effects that we argue about so lengthily, are but tributaries dropping into it. British labour costs are higher, often much higher, than those elsewhere. Therein lies the British problem, and the British failure.

Why the British? And what about trade union reform of the last decade, and the power of unions to screw up wages that it was supposed to reduce? The answer lies deep in our history, and is a national culture of which the trade unions are themselves only a manifestation.

Perhaps it was because of our pioneering role in the Industrial Revolution, saddling us with the original blame for the early hardships of the workers; perhaps it was the sturdy spirit of the preceding craft guilds; but for at least a century, the British have been uncommonly shamefaced about their labour force. The worker here, unlike elsewhere, is a blameless creature, the victim of injustice, perpetually fighting exploitation. The image is buried deep in our national consciousness. Whoever heard blame for industrial disruption being laid on the workforce? Only one culprit is named – management.

From about the middle of the last century, the great and good of this country have commiserated with the working underdogs and disdained capitalism. The attitude is endemic in the literature: read George Bernard Shaw, H.G. Wells, Galsworthy, Arnold Bennett, the Webbs. In choosing Britain rather than Germany as the place in which to write Das Kapital, Karl Marx knew a congenial intellectual atmosphere when he saw one. In the last two decades of the 19th century, parliamentarians and judges conspired to give labour associations undreamt-of immunities. Then, in 1904, the Trades Union Congress sent representatives to Parliament who were shortly to constitute the Labour Party. The UK became a trade union stronghold, the only advanced industrial country in which one of the two alternative parties was fathered, and controlled, by the trade unions.

Much, it may be claimed, has changed. The culture has not. Last year, the German engineering unions IG Metall and oTV got away with a pay rise of 5.6%, where 5.3% was generally considered the utmost the economy could bear in face of an inflation rate of 4.5%. There was nationwide indignation. This year they settled for a little over half. At the same time, British pay rises were cruising unimpeded at $6^1/_2$%–$7^1/_2$%, with inflation only at 4–$4^1/_2$%; this year they have been running at 5%, with inflation down to $1^3/_4$%. Scarcely a whisper has been heard in protest. Loud moans there have been in plenty: with typical irony, they have been all about unemployment.

This leads to thoughts about the real damage being inflicted on our economy. As a high wage, high cost, inflated economy, we lose export orders; that has already been shown. But the condition has had more important consequences, for it has contorted the whole of our economic management. The saga of how this has happened is a lengthy one, but its essence can be simply expressed: At times of good growth and high unemployment, wages rise inexorably fast; costs rise, inflation rises. The Government takes fright. It clamps down on the economy, with high interest rate, public expenditure cutbacks, tax rises – any tools to hand. The economy recoils: growth stops, demand shrinks, orders fall, company profits vanish, bankruptcy threatens. The companies retrench; they cut cost; they reduce their workforce. Unemployment rises. The workforce takes fright. Wage demands moderate. Inflation eventually subsides; recovery begins; employment rises. Wage demands revive. So the pattern goes on. It is called 'boom and bust', and the 'stop-go cycle'. We have seen it for forty years. In explanation, politicians and academics have called in every kind of sophisticated ratiocination: every interpretation of events except the one that the bare facts and figure loudly proclaim. For the workers' reputation in Britain is sacrosanct.

Bryan Gould consciously sought to avoid all political partiality, and it does not lie with an objective economic analysis to point a partisan finger. The Socialist philosophy is a worthy, in many ways a noble one. But it is now a factual economic acceptance that the Socialist approach to the economic process is gravely flawed. Mr Gould does not appear to have noticed that.

These comments however are only intended to balance Bryan Gould's analysis, and are, in themselves some evidence of how stimulating and truly enjoyable his talk was to me and, I am sure, to all those present.

PROFITS AND ECONOMIC PERFORMANCE

Summary of a talk by Martin Ricketts, Professor of Economic Organisation at the University of Buckingham and former Director of the National Economic Development Office, to members of the Economic Research Council on Thursday 29th April 1993

Introduction

The role of profits in economic development is a topic which recurs in popular debate at regular intervals. It raises questions of theoretical and even philosophical interest as well as more practical matters. The basic question upon which many more subsidiary ones turn is "do profits tell us anything about economic performance, either at the economy wide level or that of the individual business unit?"

Over twenty years ago I worked as a research assistant for an organisation called the Industrial Policy Group. It was a club whose members were chairmen of fairly large UK companies. They produced a series of papers on matters of mutual concern. Rolls Royce had collapsed and the Industrial Policy group produced a paper entitled "Economic Growth, Profits and Investment".[1] The main thesis of the paper was that profits had been falling and that a reversal of this trend was necessary if economic recovery and long term growth was to be secured. To quote the opening lines of the paper:

> "In their search for explanations of Britain's relatively poor record of economic growth in recent years, commentators have tended to ignore an exceptionally significant factor – the long term decline in the rate of profits and in their share in the national income".

The paper argued against artificial stimulation of investment by subsidies, tax allowances or other government sponsored schemes as these would in all probability lead to a waste of capital.

> "The pivotal element in any industrial revival is, in our opinion, an increase in profits ..."

Generally the reaction at the time to this paper was adverse. The Times printed a leading article under the heading "A Poor Policy for Industry". Much has changed over the intervening years, of course, and the general intellectual climate as well as the tax system now seem much less hostile to profits than they were. But were the Industrial Policy Group correct in their thesis? Business people find it natural to associate high profits with "success". At the economy wide level, however, the relationship between profits and performance is complex.

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1 Industrial Policy Group (1971) "Economic Growth, Profits and Investment".

Profits in the National Accounts

Information taken from OECD national accounts data reveals the following picture.

(i) Operating surplus as a proportion of GDP in the United Kingdom remained below that of the USA, France, Germany and Japan in every year between 1962 and 1990.

(ii) In manufacturing, gross operating surplus as a proportion of gross capital stock was well below the levels prevailing in other countries between 1978 and 1987 (the most recent date for which figures are published). The rate of profit was only about 4.5 per cent in the United Kingdom in the recession of 1981. A strong recovery was experienced in the mid 1980s to just under 9 per cent although the OECD figures for the USA, Japan and Germany were all around 12 per cent in 1987.

(iii) In 1992, for the business sector as a whole, the OECD records a return on capital of 9.5 per cent in the UK against 14 per cent in Germany and France and no less than 21 per cent in the USA. Obviously it is necessary to point out that the UK was at a very different stage in the economic cycle compared with these other countries in 1992.

This evidence of profit shares and profit rates has to be treated with a degree of scepticism. For cross country comparisons profit figures taken from national accounts sources are likely to be misleading, although for trends within a given country they may be more reliable. The major reasons for taking cross country comparisons with a large pinch of salt are that basic differences in structure such as the size of the self employed sector (the income of which is counted as operating surplus) can distort the picture, while estimates of the size of the capital stock are constructed on the basis of different assumptions in different countries.

Looking at recent trends in the UK alone, the evidence does seem to point to a general recovery of profitability. Even in 1991, the pre-tax real rate of return for non-North Sea industrial and commercial companies according to the Bank of England was 7.3 per cent. This was down from 11.5 per cent in 1988 but "profitability in aggregate has, nevertheless, remained high by historical standards".[2] In 1981, for example, the profitability of non-North Sea industrial and commercial companies was only just above 2 per cent.

This general recovery in rates of return in the UK was associated with a strong investment performance. Gross Fixed Capital Formation grew at a rate second only to Japan between the years 1979 and 1990. There seems to be some evidence, therefore, that higher profits and increased productivity growth and investment levels go together. Yet in the economics literature there is still doubt about the relationship. Two traditions have competed for the allegiance of economists over a long period of time.

The Dynamic or Classical Tradition

This tradition rests on the idea that profits provide the incentive to invest in new equipment, new technology, and new organisational innovations. Profits provide a sort

2 See "Company Profitability and Finance" *Bank of England Quarterly Bulletin* August 1992, p. 301.

of index of "economic dynamism". A quote from Adam Smith exemplifies this tradition.

> "The acquisition of new territory, or of new branches of trade, may sometimes raise the profits of stock, and with them the interest of money, even in a country which is fast advancing in the acquisition of riches ... Part of what had before been employed in other trades, is necessarily withdrawn from them, and turned into some of the new and profitable ones".[3]

With international capital markets one might wonder in modern conditions whether Smith's expectation of an increasing cost of capital will necessarily result (at least in a single small country) when new opportunities are pursued. But it is clear that Smith sees rising profits as a reflection of the uptake of new opportunities.

The other side of the classical approach concerned the sources of investable funds. The propensity to save out of profits was assumed to be higher than the propensity to save out of wages. Savings and the supply of capital were thus influenced by the distribution of income. Even in the 1960s "classical" assumptions about savings behaviour were being used in the construction of models of economic growth. My point here is that the classical system gave profits a central place in theories of growth. Classical economists were, after all, actually interested in economic *dynamics* and social evolution.

Even founders of neoclassical economics such as Alfred Marshall were essentially evolutionists, although the techniques of analysis they pioneered were to lead others in a quite different direction. Marshall[4] wrote that:

> "The tendency to variation is a chief cause of progress; and the abler are the undertakers in any trade, the greater will this tendency be".

Variations in product or process will be linked to profits, however, as experiments are tested in the market place. Marshall in the above quote is taking what would now be called an "Austrian" view of the market process. For "undertakers" in a trade read "entrepreneurs" and a modern exponent of the primacy of the entrepreneurial function such as Israel Kirzner could have written the sentence.

The Static or Neoclassical Tradition

The great achievement of this tradition was the elaboration of the conditions required to establish a competitive equilibrium. Profits were central to this achievement in a somewhat paradoxical way. In a competitive equilibrium there are no profits. As Schumpeter[5] put it:

> "With perfect competition prevailing, firms would break even in an equilibrium state – the proposition from which starts all clear thinking about profits".

3 *The Wealth of Nations* Vol 1, IX. 12.

4 Alfred Marshall (1925) *Principles of Economics*, 8th Edition, Macmillan, London, p. 355.

5 Joseph Schumpeter (1954) *History of Economic Analysis*, Allen and Unwin, London, p. 893.

Schumpeter states that thinking, if it is clear, will start from this proposition about profits in competitive equilibrium. He does not say that all thinking starting from this proposition will be clear. Problems of interpretation arose when the theoretical concept of a perfect equilibrium became not so much a benchmark and starting point for further analysis but a description of an "ideal" arrangement. Once it became accepted that competitive conditions should lead to an equilibrium in which all prices reflected social marginal costs and benefits and where welfare was, in a special sense, *maximised* all departures were viewed with great suspicion. Since departures from competitive equilibrium involved profits and losses, these too became viewed with suspicion.

If zero profits were associated with competition then it was a deceptively seductive step (even if logically suspect) to associate positive profits with lack of competition. It was a further small step then to argue that the social losses from monopoly power might be related to the level of profits earned by businesses.

At first profits were seen merely as *symptoms* of output restrictions and higher prices. The value of lost output was estimated from the profits earned but the profits themselves were simply transfers from consumers to producers. Later, profits began to be regarded as representing social losses in themselves. The argument was that profitable positions must be created either by market restrictions or government actions and that firms will waste resources in trying to create such restrictions. The activity of investing resources in lobbying governments or keeping competitors out of a market became known as "rent seeking". Even advertising expenditure was added to the list of rent seeking activities and was counted as socially wasteful.

A study at the end of the 1970s estimated that monopoly led to a loss of 13 per cent of gross corporate output in the mid 1960s in the USA.[6] This figure was calculated by adding together all post tax profits, advertising expenditures and losses due to restrictions in output. The UK figure was lower – about 7 per cent in 1968/69. It is interesting to consider the list of monopolists in the UK identified as imposing the greatest social losses. This included Unilever, ICI, Rank Xerox, IBM (UK), Beecham, Marks and Spencers, Woolworths, Ford, Distillers, Rank, Thorn and Cadbury Schweppes.

Monopoly Power versus Competitive Advantage

It is instructive to contrast this approach with that of a 1991 study which appeared in the *Business Strategy Review*.[7] A rather different list of firms appears with figures showing profits as a percentage of sales. There are some overlaps even after 20 years – for example Smithkline Beecham and the Rank Organisation. But in addition there is Glaxo, Cable and Wireless, Reuters, BT, Guinness, Wellcome, Pearson, BTR, Fisons, British Gas, RTZ and Burton. Not only is the list substantially different, but the interpretation put upon the profitability figures could not be more distinct.

6 Keith Cowling and Dennis Mueller (1978) "The Social Cost of Monopoly Power" *Economic Journal* Vol. 88, No. 4, pp. 727-48

7 E. Davis, S. Flanders, and J. Star 'Who are the world's most successful companies?' *Business Strategy Review* Summer 1991. p. 1-33.

In 1991 Glaxo and Cable and Wireless were the two most profitable companies, when measured against sales, in the world. In the study of business strategy this is seen as an excellent sign. Pure profits derive from "competitive advantage". Note the difference in rhetoric here. Instead of the neoclassical economist's "monopoly power" there is "competitive advantage". Yet objectively speaking these two concepts amount to the same thing. Pure profit is calculated by imputing a "competitive" return to all the capital used in an enterprise and subtracting this from the operating surplus. The excess is "pure profit". For some analysts pure profit is a symptom of social loss. For others it represents successful adaptation or innovation unmatched by competing firms. The ideological interpretations could not be further apart.

The findings reported in the *Business Strategy Review* raise several questions.

(i) How can it be that the UK has some of the world's most profitable companies yet OECD figures show it to be below most other advanced countries in terms of profit shares and profit rates? There seems to be a conflict between micro (firm level) evidence and macro (national income) evidence.

(ii) Is the debate about the interpretation of profits entirely a matter of ideology, or can evidence be adduced in support of one interpretation or the other?

(iii) Are measured operating surpluses or accounting profits suitable measures of competitive advantage in modern conditions, or would alternative approaches be more appropriate?

Some Tentative Answers

(i) With respect to the first question there is always the possibility that the OECD data give a totally false impression for the reasons mentioned earlier. Let us suppose, however, that there is something to explain and that the whole "problem" is not the result of deceptive data. A possible explanation is that the sources of pure profits differ between the UK and elsewhere. In the UK, profits may be more concentrated in particular "success stories" while in Japan they may be spread more widely across industry and commerce.

Competitive advantage ultimately derives from the possession of assets that others find it time consuming and costly to replicate. Assets should be interpreted here to include not merely physical equipment but intangible assets such as "know how". A common taxonomy of the sources of competitive advantage includes market entry barriers, technological advantages, teamwork and reputation.[8] The ability to work effectively as a team, for example, can be seen as a form of "know how" which is a valuable asset although not one that is exchangeable on the market.

Looking at the list of UK companies identified above as earning high profits as a percentage of sales it can be seen that several are regulated "natural monopolies" (BT and British Gas) while pharmaceuticals figure prominently (Glaxo, Smithkline, Wellcome and Fisons). Profits in the area of pharmaceuticals are likely to reflect the

8 John Kay (1992) 'Innovations in Corporate Strategy' in *Stimulating Innovation in Industry* National Economic Development Office Policy Issues Series, Kogan Page, London.

returns available to particular patented innovations. A celebrated recent example is that of Glaxo's drug Zantac – a treatment for peptic ulcers.

It is when we come to teamwork and reputation as sources of competitive advantage that doubts about UK performance become more pronounced. Often technical knowledge is difficult to protect by means of patents. Further, there is a clear distinction between the ability to produce innovations and the ability to use them. Paul Geroski of the London Business School has argued that performance is much more closely related to the latter than the former.[9] The ability to make the most of unpatentable "know how" or to use innovations which may have been created elsewhere is linked more to organisational capability than to purely scientific expertise.

In the case of Japan, for example, it is often argued that the "architecture" or organisational structure of Japanese firms enables them to generate profits from teamwork and reputation more efficiently than firms in the UK. In particular the Japanese contractual environment is said to be more conducive to the generation of such profits. Stable "lifetime" contracts implying the existence of a great deal of trust, a high degree of flexibility in working arrangements, and the generation of wide "institutional knowledge" within the workforce contribute to the establishment of competitive advantage based on teamwork. The end result is characterised as a contractual environment which is "obligational" and trusting in nature. In contrast, UK contracting is seen as "arms-length", "individualistic", involving rather low levels of trust with shorter term commitments always in danger of being severed.[10]

Whether the differences in contractual styles are really as great as they are sometimes represented to be, and whether the Japanese system will prove robust in the face of economic adversity remains to be seen. The discussion is relevant here only in so far as it impinges on differences in the sources of profits in the two countries. One tentative response to the observed paradox of highly profitable firms existing in a relatively low profit economy is that, in the UK, profits are associated with industries where there are monopolistic elements, or where technical advances can fairly easily be patented. In Japan "architecture" and teamwork are more important and result in a wider and thinner spread of rewards in the form of profits.

(ii) In general, should higher profits be viewed as entrepreneurial or monopolistic? The dynamic interpretation of profits is most persuasive where profits co-exist with rapid economic growth. As William Baumol [11] has recently argued, if entrepreneurs divert their activities into rent seeking and military activities their private returns may be substantial but economic progress is likely to be restricted. Throughout history the incentive for entrepreneurial effort to focus on politics or crime rather than commerce has been the usual state of affairs. Societies in this predicament may yield high rents and

9 Paul Geroski (1991) 'Innovation and the Sectoral Sources of UK Productivity Growth' *Economic Journal* Vol. 101, No. 409, pp. 1438-51.

10 A recent (February 1993) Guardian survey of the State of the UK economy by Will Hutton emphasises these points.

11 William Baumol (1990) "Entrepreneurship: Productive, Unproductive and Destructive" *Journal of Political Economy* Vol. 98, No. 5, Part 1, pp. 893-921.

profits to some, but they will be economically stagnant. In the post-war era, the combination of high rates of growth with historically high rates of profit in many countries suggests that the processes described by Adam Smith and quoted earlier may have been at work.

The entrepreneurial interpretation of profits also gains credence when profits can be plausibly associated with the process of innovation. A good example here is the experience of industries subject to inward direct investment. In the UK, cars and electronics as well as many other sectors have received much direct investment from overseas. Foreign business accounted for 26.7 per cent of net capital expenditure in manufacturing industry in 1989. The companies undertaking the investment have knowledge not available to indigenous firms, knowledge that the latter could not easily acquire. Much information is of this type, transmitted through learning by doing and by direct experience within a given firm. Thus, the multinational firm as a vehicle for capitalising upon internally generated knowledge is important for transmitting information from one country to another – especially organisational information. During this process entrepreneurial profits are generated.

(iii) An implication of the dynamic view of profit is that we should not expect the returns to competitive advantage of entrepreneurship always to accrue to capital. There may have been a time when the entrepreneur and the provider of capital were closely associated. In the modern economy the two activities are becoming disentangled. Capital is provided, often through intermediaries, by people who do not act as entrepreneurs. Within the firm, on the other hand, the entrepreneurial talents of the team are exploited. An important problem is to prevent all the profit being dissipated by squabbling over its distribution (i.e. by rent seeking). Writers on Japanese organisations have emphasised the role of management as referees in the process of distributing the firm's surplus between the various claimants.[12]

Thus, the traditional troika of land, labour and capital each receiving an identifiable return in rent, wages and profit respectively is dissolving in the face of modern experience. Labour now receives all three types of income. Special skills (human capital) are rewarded with a return conceptually equivalent to that on certain types of physical capital, routine unskilled labour yields a wage i.e. compensation for time and effort, while returns in excess of these are rewards for entrepreneurial flair. Within the modern firm, contracts and relationships are beginning to reflect the complexity of this situation. The ability to structure such relationships is ultimately what is meant by the "architecture" of the firm.

Concluding Comments

In modern conditions, profits are indicative of successful innovation. This does not, of course, imply that government attempts to boost profits artificially would be desirable. As the Industrial Policy Group argued in 1971 these profits would merely reflect restrictive policy and not successful economic development.

12 e.g. Masahiko Aoki (1984) *The Co-operative Game Theory of The Firm*, Clarendon Press, Oxford.

The low relative rates of profit for the UK recorded in national accounts statistics are therefore a matter of concern but

(i) the reliability of the data is very suspect and
(ii) modern approaches to competitive advantage suggest that traditional measures of surplus or pure profit may be misleading. If some of the literature on the architecture of firms is valid, it leads to the conclusion that pure profits can be received by the labour force. This will happen when the firm's surplus is to some extent generated by the entrepreneurial activities of the entire team.

The classical conception of profit as an index of change and a stimulus to enterprise has gained recently over static neoclassical orthodoxy. But, even as this has happened, classical notions about profits as a return to capital have been transformed. Empirical work has been unable to keep abreast of these conceptual developments.

A NEW AGENDA?

By Mr Sydney Shenton

There is much truth in the old business saying that if it is not right at the top it will never be right at all.

The signs of so many policies and their implementation becoming increasingly wrong and misguided emanating from the top in Government explains the call from inside the Cabinet down to practically every single man in the street for a revised agenda. Eventually, even in our straitened and restricted political system this should soon prove quite irresistible. All the more so for there being a surprising degree of unanimity as to what we need to be doing right across the financial, industrial and whole community.

It will be useful to run through what should be on the agenda to remind ourselves both of what could be done and to perhaps bring the day when we set about these objectives and programmes that little bit closer.

First, the present target growth of well under 3% will do little to reduce our mounting double trade imbalance, fiscal and real, nor make any worthwhile impact upon our mass unemployment, devastating socially and economically.

Moving to both a target and achievable growth rate of nearer 5% would transform our prospects, and what is needed should be any Government's top priority. In essence three things are needed, get interest rates down and keep them at the lowest level possible, get the exchange rate right, down at a level to give exports a maintained opportunity, and watch credit, regulate sensibly with the need for growth constantly in mind. If fears of inflation disturb this programme we have little chance of sustained recovery, and the baleful influence of the Treasury seems to be pushing absurdedly for

a higher pound which will undo all the fortuitous help we receive by being forced out of the ERM.

The pound has been calculated at around the 18% in real terms above what it was in 1970 at its recent lowest level. To aim to strengthen it should be unthinkable. Also with interest rates down as far as possible, increases not even considered. Credit restraint will be essential eventually but to rush in quickly at the first signs of increased consumption and housing activity would be extremely foolish and in this area if the Treasury and the Bank of England are permitted to influence the pushing up of the interest rates we will soon be back into recession.

Long term measures to encourage transfer from spending to saving and investment are another kettle of fish entirely and wage restraint will be needed. This will need help including putting the brakes on the quite disgusting increases taken from boardrooms and the catalogue of 'golden good byes'. Huge salaries and pensions should be curbed and need to be proscribed quickly. There are many ways, including the tax system.

So right at the top of the agenda, everything to sustain growth.

Next, deeds not just words, to rebuild our manufacturing and construction capabilities. Here again quite incredibly, the Treasury is reported to have doubts about such policies. Tax incentives to encourage capital investment and research and development can only be beneficial.

Then it should be impossible to deny we need some sort of an energy policy directed to long term national benefit rather than short term private profit. This strategy need not be in the least incompatible with private ownership, more direction and powers to regulation are all that is needed.

Staring everyone in the face, except apparently Government and their rapidly stumbling and discredited institutions, is the urgent need to rebuild our infrastructure and transport systems up to international standard. Over concern as to the effect on public sector borrowing requirement would be overcome very quickly by the immediate gains in unemployment costs and extended recovery profits. The stimulation would be substantial and immediate. In short if we permit fears about inflation to overrule vital renewal of our commercial and industrial capability, we are doomed to continued slump and decline. Our industrial base is far too small and we must focus upon rebuilding and extension of every aspect, to assist companies large and small, who in this sector alone can reduce our trade deficit and bring down the crippling level of unemployment.

This leads into the function of the banking and financial market institutions which must be made to service and assist the manufacturing and industrial sector much more flexibly and less expensively. A whole host of measures how this can be done are currently being pressed on Government by the CBI and others, including the new Manufacturing and Construction Industries Alliance, a joint venture from all political parties and industry.

Wage restraint and credit control are being undermined by the greed rampant in so many of the board rooms across the country, and just at a time when the small business firms need every help they can get, banks and financial organisations are restricting credit and increasing the cost of finance already internationally excessive. No wonder surveys here from small business are the gloomiest in Europe.

Strong action to correct these two harsh faults would be inexpensive; place no strains on public finance and bring great benefits immediately. It would appear that only the faith in the ability of the totally free market to solve all problems, amounting almost to belief in the supernatural, stands in the way.

Above all bringing the whole country together in united effort and purpose would be abandonment of the seemingly endless policies of making the rich richer and the poor poorer. This is stupid economically, as a better fair spread of earnings and wealth would be hugely beneficial and is quite abhorrent socially. A single example will suffice of the decision to add VAT to fuel charges. This clearly disadvantages the lowest paid of the community and whilst there is need to raise more public funds and reduce government borrowing, there is a wide variety of options in the tax system which would not have offended people's sense of fair play and which would have been more effective. Only if we pay far more attention to policies which are socially cohesive are we going to attain a more contented and law abiding nation as well as a more prosperous one. The Prime Minister has declared his belief in a classless society, and he needs urgently to commence long overdue measures to match words with deeds.

All the suggestions and measures indicated here are both simple and very widely supported and acceptable. No musical chairs in the Cabinet or great changes in policies are called for. Just greater competence and grasp. Plus of course what the Frogs commented upon in Aristophanes' play, when they remarked that the City States of Greece made no progress and indeed withered and died if at the same time they elected wise leaders they did not also find those with the moral strength to lead the citizenry as a whole.

THE EDWARD HOLLOWAY COLLECTION REVIEW

***The Political Madhouse in America and Nearer Home* by Bernard Shaw**
Published by Constable & Co, London 1933.

This is Bernard Shaw on "Political Economy" at his best – in a lecture given in America to the Academy of Political science. It is a lecture full of banter and good humour on world events of the time and a lecture which acknowledges Shaw's debt in economic perceptions to certain American thinkers, notably Henry George who "set me on the economic trail, the trail of political science".

He began with taunt and appreciation of the American character. "What is the secret (he asked) of this tremendous man, who speaks so splendidly and has nothing to say?" He proceeded to discuss the American Constitution "which is being amended out of existence" and gave an amusing dismissal of Hollywood as a place "corrupting the world with the doctrine, not of sex appeal, but of Anarchism".

Then he proceeded to more serious matters and in his passage on the rise and fall of civilizations and the future of mankind one feels one is in the hands of the master – the master of words and conceptions. Returning to Americans he praised their hospitality and commented on their "rage for publicity" and their love of lectures. And he had great things to say in honour of the Mormons and their period of acceptance of polygamy.

But then to economics... "I admit that your existing situation is not a very promising one. Your proletariat is unemployed. That means the breakdown of your capitalist system, because as any political scientist will tell you, the whole justification of the system of privately appropriated capital and land on which you have been working, is its guarantee, elaborately reasoned out on paper by the capitalist economists, that although one result of it must be the creation of a small but enormously rich propertied class which is also an idle class, living at the expense of the propertyless masses who are getting only a bare living, nevertheless that living is always secured for them. There must always by employment available; and they will always be able to obtain a subsidence wage for their labour." "When that promise is broken, then the capitalist system has broken down."

Now, he says, the employer in the form of an employed manager, has fallen into the hands of the financiers – "They are the present masters of the situation". This is "dangerous" because the financier "is the very contrary of the statesmen". He is a man who (at 5% interest rates) values everything at 20 times income and, as bankers, America has given them a certain "hidden power" by enabling them "to enter on the most lucrative of all businesses: the business of money lending with other people's money." "But now you see that this natural discovery made by the goldsmiths and exploited by them as bankers, sets up automatically in large civilizations like yours a money power so irresistible that it becomes a political and industrial power, not to say a religious power of the most formidable magnitude. Any nation that leaves this power in the hands of irresponsible private men to use simply for their own enrichment, is either politically ignorant or politically mad to the utmost possible degree." ... "The first thing you must do to get out of your present mess is to nationalise your banks."

Shaw then turns to the "delusions of financiers" – the chief amongst them being the idea that a country is strong if it runs a balance of trade surplus. He says "Now this seems reasonable enough to people who think in terms of money. To people who think in terms of goods it is raving nonsense. Foreign trade is nothing but barter conducted with money; and to maintain that in barter the more you give and the less you get in exchange, the more prosperous you are, is to qualify yourself for the asylum."

He continues in a vein perhaps interesting to Japan today ... "This craze for getting money into the country makes the financier very keen on foreign investments. To begin with, he makes a good deal of money by floating foreign loans; and the first effect of foreign loans is to stimulate exports. But the ultimate effect is to annihilate exports by producing a state of things in which the nation lives on an income from abroad as interest on the foreign loan, and exports nothing in return. The financier is caught in his own trap; and you are caught with him. He wants more exports, more exports and still more exports. To stimulate them he organises foreign investments which mean more imports, more imports, and still more imports. He is working at the same time for a policy of producing and exporting everything, and for a policy of importing everything and producing nothing. The result of these two contrary impulses struggling in his brain is, that you revere him as an omniscient master of finance when he has reduced himself to nothing but a neurotic gambler with an insoluble complex. If it were not that his left hand is continually undoing the work of his right he would have ruined you long ago."

The risks of such a policy of overstimulating exports and making overseas investments are that eventually foreign countries will repudiate the debt – perhaps by the simple expedient of taxing your income before it leaves their countries.

This all leads Shaw to a discussion of the Bolshevic revolution "made successful by American efficiency experts" and to his support for Communism under Stalin. A rum thought! – but we can still read him with interest when he says "If you cannot appreciate American Communism, at least learn to appreciate the benefit to America (American financiers?) of having other countries Communistic. Think of the United States with not only Japan capitalist, but Russia capitalist and China capitalist! You may well shudder."

Shaw's wit and command of English make this lecture worth a re-read whatever the contents. But more than that one has that marvellous feeling of being reminded of a bygone age when informed laymen of intelligence felt able to state with confidence basic truths in economics, when the broad picture could be approached without reference to specialists for every mini-bridge crossed. We surely need a return to that spirit – not to handbags and shopping economics but to political economy in broad strokes of common sense.

J.B.

THE CREATION OF A CIVIL ECONOMY IN RUSSIA

The Economic Research Council Discussion Paper "The Creation of a Civil Economy in Russia" was presented by the authors, Tony Baron and Robert McGarvey, to a large gathering of members and guests on Wednesday 26th May, at the St Ermin's Hotel.

The authors argued that progress in Russia would be better achieved at this stage by policies more akin to 'Mercantalism' than to 'Laissez faire'. The point was made that economic growth depends upon the success of businesses and that businesses in Russia need a climate offering security and predictability if they are to have the confidence to invest. Such security and predictability could be provided by the Russian government if it is prepared to offer a degree of protection against competing imports and a system of licensing to limit competition – within a framework of co-ordination comparable perhaps to so-called 'indicative economic planning' in France just after the last war.

Further, the authors argued that the West, rather than granting aid which would merely raise Russia's exchange rate and pay the pensions of retired Communist functionaries, should accept a period ofmercantilism and accept a period of restricted exports to Russia whilst opening our own markets to Russian-made goods.

This thesis was well received and a lively question time followed.

Members who have not yet seen the Paper and would like a copy should send £2 to the Hon. Secretary.

LETTERS

Sir,

T.B. Haran's long letter in your Spring issue purveys ideas that are rapidly carrying the world to calamitous disintegration. At the start he categorically denies that banks create money by lending out more of it than people have deposited with them. Here is a matter of fundamental importance. If banks do not create credits how does new money come into being, why is the whole world in huge, interest-bearing indebtedness to the private banks (now over four million million dollars in the USA, for example), and why does that egregious and ever growing gap exist between total incomes and total prices of goods and services with its global poverty amidst abundance?

Of course Mr Haran is right in stating that "money is subject to a process of continuous creation and destruction". But by whom? Industry doesn't create money; nor do governments to any large extent. At present only banks do so and they create it out of nothing but ink, paper and electrical impulses in computers up to thirteen times the value of the deposits people have left with them. Surely that fact is by now generally known and accepted. At least twenty authorities, including a number of bankers, can be quoted to support it; even the late, revered Lord Keynes eventually agreed, but now let five authorities suffice:-

"Banks create credit. It is a mistake to suppose that Bank Credit is created to any important extent by the payment of money into the banks." – *Encyclopaedia Britannica*.

"The Bankers manufacture Credit by a mere stroke of the pen." – W. Hadley Robinson, Fellow of the Institute of Bankers.

"Every bank loan and every purchase of securities creates a deposit, and every repayment of a bank loan and every sale destroys one." – Reginald McKenna, erstwhile Chairman of the Midland Bank and Chancellor of the Exchequer.

"It is not unnatural to think of the deposits of a bank as being created by the public through the deposit of cash representing either savings or amounts which are not for the time being required to meet expenditure. But the bulk of deposits arise out of the action of the banks themselves, for by granting loans, allowing money to be drawn on an overdraft or purchasing securities, a bank creates a credit in its books, which is the equivalent of a deposit." – the late Lord Macmillan.

"Banking was conceived in iniquity and born in sin. Bankers own the earth; take it away from them but leave them with the power to create credit, and, with a flick of the pen, they will create enough money to buy it all back again." – Lord Stamp, a Director of the Bank of England.

The trick began with the goldsmiths of old who found they could issue more receipts for gold than the actual amount of gold deposited with them for safe keeping – and without any awkward questions being asked. These receipts became a form of paper money that was generally acceptable so long as all the depositors of gold did not claim their property at the same time. It was a con trick then and so it remains in its modern guise.

Bank notes, declares Mr Haran, are only titles to money, not money itself. So what the hell is money? Can you eat it or build houses with it? The notes of the Fiduciary Issue are as much a form of money as paper cheques. Indeed money can be anything from cowrie shells to playing cards that everyone will accept in exchange for goods and services, an improvement on barter so long as it is not abused in such ways as it is today. Now the money we use consists of 1/2 per cent coinage, 4½ per cent bank notes and 95 per cent paper cheques and book entries. Its abuse lies in the debt-generating monopoly of credit creation and cancellation by the banks that is keeping the whole human race chronically short of purchasing power. The results are disastrous, not only in general, needless deprivation but, as a result of competitive struggles for export markets, in the threat of horrendous international warfare.

The system works as though only 100 passengers may take the train from London to Edinburgh when it can carry 200, simply because only 100 tickets have been printed. This is mad. To issue the correct number of tickets – and here Mr. Haran and I agree – need not produce inflation. The very existence of inflation (a sort of fluctuating poll tax) means that we are not doing our money sums correctly.

So far as I can understand him, Mr Haran seems to be arguing from false assumptions. In conclusion he states, "We need to change our ways and not our paper currency. An absence of inflation, full employment and stable money could then be our rewards." To remove inflation and render money stable are excellent aims, but is that Calvinistic call for full employment in this technological, labour-saving age any longer either a possible or a desirable objective? Unless we now accept the existence of a huge, unearned and as yet undistributed increment in the production of real wealth, our civilisation with all its wonderful potentialities for the good life in a genuine, that is an economic, democracy must ineluctably be doomed.

Yours truly
Eric de Maré
The Old Chapel
Tunley
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GL7 6LW

Sir,

At the bottom of a major recession with low inflation the current cost of borrowing by British business is far too high, bearing in mind repayments have to be made after tax.

Banks having recently widened their profit margins on lending by at least 0.5% to all non-plc businesses, rates now vary between 8.5% and 10.5% across the board: that is some 7 to 9% *above* the rate of inflation.

In the last major recession when inflation was as low as 1.5% the borrowing cost to business was no more than 3% above inflation. With additional social and corporation tax far higher than pre-war, borrowing costs to non plc domestic business is the highest

in real terms in British history – a fact that seems to have totally escaped the minds of officials in Whitehall who advise their political masters, most of whom have never managed anything other than political affairs in their lives.

Unless real rates adjust to normal, there is no chance of real recovery which involves debt repayment of past and future business borrowing before the next cyclical business decline.

Instead of crowing about a recovery when we have merely reached the bottom of the hole, before we have hardly started to climb out, Whitehall officials and their masters need a big shake out ("set aside" they call it in the agricultural industry), to produce a remedy.

There is no need for British business to pay the same rates as the Government has to pay to service its overseas borrowing and budget deficits and to hold up the £ sterling above what it is worth. Other countries do not do this. Germany has at least two official borrowing rates: that which relates to the value of the D Mark is the international rate while the other which is much lower applies only internally to German business borrowers. The total amount lent to German business at the lower rate is under control by the State, so that money supply does not explode or is misused to service personal over consumption on tick. The lower "Bank Rate" is for business only.

Other countries have operated two tier rates – if they can do it successfully, so can we.

One final point: banks are borrowing from business and private clients at about 5% at most and lending on at a 100% mark up: this is far too high now that Bank charges are levied at record levels for every item of expense, whilst full security is obtained from all so called small business as collateral to cover non-repayment by British business. Government legislation could easily curb such usury at least in respect of business: mark ups should be cut to 50%, resulting in charges above base rate closer to what appertains in the USA. Until we are right out of this recession, business with collateral should never pay more than 1.5% above base, giving a current gross return on bank shareholders funds of 7.5% after bank charges. At the same time Whitehall must help Banks (rather than milk them). Banks also need to rebuild funds to lend internally rather than to unsecured international borrowers. Corporation Tax should not be uniform: during this recession domestic industrial business and Banks should have corporation taxation reduced by 10% at once.

Yours faithfully
D.M.G. Pilleau
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GU15 4LG

NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

OBJECTS

i) To promote education in the science of economics with particular reference to monetary practice.

ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.

iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

v) To publish reports and other documents embodying the results of study and research.

vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.

vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.

BENEFITS

Members are entitled to attend, with guests, normally 6 to 8 talks and discussions a year in London, at no additional cost, with the option of dining beforehand (for which a charge is made). Members receive the journal 'Britain and Overseas' and Occasional Papers. Members may submit papers for consideration with a view to issue as Occasional Papers. The Council runs study-lectures and publishes pamphlets, for both of which a small charge is made. From time to time the Council carries out research projects.

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Individual members	£25 per year
Corporate members	£55 per year (for which they may send up to six nominees to meetings, and receive six copies of publications).
Associate members	£15 per year (Associate members do not receive Occasional Papers or the journal 'Britain and Overseas').
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APPLICATION

Prospective members should send application forms, supported by the proposing member or members to the Honorary Secretary. Applications are considered at each meeting of the Executive Committee.

APPLICATION FORM

To the Honorary Secretary
Economic Research Council
239 Shaftesbury Avenue
LONDON WC2H 8PJ.

Date ....

APPLICATION FOR MEMBERSHIP

I am/We are in sympathy with the objects of the Economic Research Council and hereby apply for membership.

This application is for	Individual membership (£25 per year)
(delete those non-applicable)	Corporate membership (£55 per year)
	Associate membership (£15 per year)
	Student membership (£10 per year)
	Educational Institutions (£40 per year)

NAME ....
(If Corporate membership, give name of individual to whom correspondence should be addressed)

NAME OF ORGANISATION ....
(if corporate)

ADDRESS ....

....

....

PROFESSION OR BUSINESS ....

REMITTANCE HEREWITH ....

SIGNATURE OF APPLICANT ....

NAME OF PROPOSER *(in block letters)* ....

AND SIGNATURE OF PROPOSER ....