BRITAIN & OVERSEAS

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

Autumn 1994 Vol. 24, No. 3

Editor: Jim Bourlet

Published quarterly by
The Economic Research Council
239 Shaftesbury Avenue, London WC2H 8PJ

Price: U.K. £12 Australia $25 Canada $25 New Zealand $35 U.S.A. $25 Japan ¥4,000

MEMBERSHIP

Membership of the Economic Research Council is open to all who are in sympathy with its declared objects. The minimum annual subscription for individual members is £25 for full members, £15 for Associate members, and Student members £10.

Corporate membership is open to all companies and other bodies, minimum annual subscription £55 (Educational institutions £40) in respect of which they may send up to six nominees to any of the Council's discussion meetings and lectures.

THE TWILIGHT OF MEANINGFUL ECONOMICS

A talk by C. Gordon Tether, President of the Society for International Development and Author of the Lombard column in the Financial Times for over twenty years, to members of the Economic Research Council on Tuesday 20th September 1994

It gives me great pleasure to be addressing you again. I believe that there is nothing more urgently needed today than competent economic research into the baffling economic problems that are besetting us on all sides. There could obviously hardly be an audience more appropriate to talk to about these problems than that assembled here tonight and see what kind of answer could be given to the question that always presents itself when economic issues are under discussion, and at present seems to be looming larger than ever – what happens next?

When I last addressed you, I believe, dear old Edward Holloway was very much in the Society's driving seat. He and I for some years had a double act going. It was concerned with endeavouring to demonstrate the strength of the argument for an overhaul of the arrangements whereby the State granted the banking system the privilege of creating the credit needed to bridge the gaps in the national accounts and to pay it relevant sums – in the form of interest on Treasury bills and so forth on such created credit at the expense of the taxpayer. His contention, with which I concurred in my Lombard column in the Financial Times, was that this was unfair to the public which had to bear the ultimate burden. Official consideration of the idea never appeared to go beyond the response that these cosy arrangements worked so well that it would be a shame to disturb them.

I myself had to drop out of the debate in the end because the Financial Times acquired a new editor who, having been brought up in Germany, took the view that even independent columnists had to be prepared to subject themselves to appropriate discipline from their superiors and, since I could not see how that could be reconciled with the independence my column had enjoyed for 20 years, I eventually got thrown out. But Edward, if I remember rightly, carried on. And, indeed, I think I have seen the same issue surfacing from time to time in your journal since he sadly disappeared from the scene.

A thought that immediately struck me when I started jotting down notes for this talk was that the appropriate way to begin an inquiry into the question of how meaningful economics was today, lay in casting an eye back to see how meaningful – in the sense, that is, of achieving what it was supposedly setting out to do – had its performance been over the centuries that have passed since it started emerging as a science of its own.

That set me reaching, on one of the very few occasions I had done so since I acquired it, for a replica version of the original Encyclopedia Britannica that made its appearance in the bookshops in 1771 at the end of a gestation period lasting some three years. I should explain that my ownership of these venerable works is not the product of an inability to resist the solicitations of a door-to-door salesman. It came about because I was for many years furnishing articles at the request of the present management to be used for the periodic revision of the basic work and for the Britannic

Book of the Year, the purpose of which is to keep everyone suitably updated between the revisions. One year the publishers – hard-headed Americans these days – hit on the idea of offering to pay the contributors in kind by giving them the replica versions of the original issue. As the normal rewards were not exactly generous, the case for accepting this alternative was impossible to resist.

The first thing that strikes you when you make the acquaintance of the 1771 edition is that, although the three volumes of which it consists all have some 700 pages, the first one manages to get no further than covering the A and B letters in the alphabet, whereas the second runs all the way from C to L and the third from M to Z. The imbalance conjures up visions of an editorial meeting held to consider the rest of the programme when the first volume had been put to bed, with a disconcerted chairman starting the discussion with "Christ Almighty", or its 1770s' equivalent. "If we go on like this it will be the end of the bloody century before we get this job completed." !

I have to tell you, if you have never come across it yourself, that the 1771 Encyclopedia Britannica does not make good reading at bedtime or at any other time of day for that matter. The printing is not easy to cope with and the presentation is one that even an intellectually-advanced reader of the Times – let alone his more lowly Sun newspaper equivalent – would be apt to lose patience with at no great lapse of time. But it has to be said that, when it comes to getting light thrown on the question of how meaningful the science of economics had become when Oliver Goldsmith was hitting the headlines with "She Stoops to Conquer", it is a veritable gold-mine,

Neither economics nor political economy – the term that economics was known by in the earlier days, is recognised as a subject. Nor is there any reference to Sir Thomas Gresham who two centuries before, had founded the Royal Exchange and put in place one of the first pillars of economics with the enunciation of the famous principle that I am sure everyone here will be familiar with. It is true that one of the cardinal elements that go to make up the economics mix – money – is given fourteen pages. But this is about the only element discussed and the space it gets compares very poorly with the 110 pages devoted to medicine and the 150 that anatomy receives.

That may not seem all that remarkable seeing that the facts of life were perceived in a very different order of priorities in the second half of the eighteenth century from what they are today. But what may surprise you, bearing in mind the importance of the role that economic realities have come to play in the affairs of the State and its citizens, is that the science hardly ranks any higher in the popular estimation today than it did all that time ago.

Economics is disposed of in less than a half a column in Hutchington's 20th Century Encyclopedia. Anatomy gets seven times as much. So there is the same relationship between its treatment and that of money in the 1771 edition of the Encyclopedia Britannica. The Macdonald Illustrated Library's "Book of Ideas", with an editorial board made up of some of the great thinkers of this century, doesn't consider economics worthy of a subject heading at all. It contains references to a few of the great names in economics, such as John Maynard Keynes and John Stuart Mill, but they get only a few lines each and then mostly only because of the philosophical content of their work. The Readers' Digest "Book of Facts" allocates a couple of columns to

economics and great economists but "Myths and Legends" gets seven times as much.

So economics has remained very much the poor relation of the other sciences that it was two centuries ago. And if one measures the progress it has achieved in relation to theirs over that period, one can get at least part of the answer to the question "Why?".

The 1771 Encyclopedia Britannica's 110 pages on medicine begins by stressing: "Men would never think of any particular regimen or mode of living in order to preserve health before they felt pains which accompany the want of it." So no preventative medicine then. Moreover, from one end to the other it is constantly referring to the importance of the part that bloodletting should play in the treatment of all manner of diseases – or, alternatively because the physicians of the day were clearly apt to insist on it when they could not think of anything else to do, should not be resorted to. Such is the level of expertise that those experiencing nose-bleeding are all but warned that they should start writing their last will and testament.

The matter around which the "Money" section of the 1771 Encyclopedia Britannica revolves is the overriding importance of preserving the value of currency against the many threats that it has to cope with from the debasement of the coinage, the advent of paper money and the failure of the State itself to face up to its responsibilities in this field. Yet the treatment of these same problems is still at the heart of much discussion about economic affairs today, so little progress having been made in the interim towards finding the right answers.

Let us move on to look at what has happened in the century now drawing to its close. By the time it opened, economic activity having been boosted in major degree by the Industrial Revolution, a lot of experience had been gained about the role it performed in conditioning the life of the citizenry and their Governments. There had been crises arising from the upsurge swinging of the activity pendulum – a phenomenon that had emerged as an inescapable concomitant of the functioning of the Capitalist System. Was there any awareness of the need to work towards a greater understanding of these things so that steps could be taken to bring them under control in the interests of humanity as a whole? Listen to what Edward Holloway says in the first few lines of his remarkable book – 'Money Matters – a Modern Pilgrim's Economic Progress':

"Had I been asked in the 1920s what I knew about Economics, I should have truthfully replied 'absolutely nothing'. I subsequently found", he goes on to say, "that this was by no means an unusual state of affairs and that this ignorance was shared by the majority of the population, including MPs, Industrialists and others." He would not have been exaggerating if he had said pretty well the whole of the population along with the people who had responsibility as Parliamentarians, Employers and opinion-makers, for ordering their lives.

It has to be admitted in defence of the science of economics that it has had constantly to do battle with other forces – emanating from the political field in particular – to an extent that other sciences have not. But it can certainly be argued that, if its performance had been more meaningful, those forces would have found it much less easy than they have to see that their ideas prevailed. Now to what has been happening in the present century, we can find two first class examples of this fundamental truth straight away.

The first concerns the handling of the economic aftermath of World War I. The blunders perpetrated in the infamous – as it has now come to be labelled – Treaty of Versailles – were essentially economic. They arose from the insistence of the politicians on the winning side on imposing economic punishments on the defeated enemy. They were punishments calculated to provoke the kind of reaction that could provide the basis for the continuance of strife in a different form – which, of course, in due time they did in the shape of the emergence of Hitler and, later, in the six years of World War that he helped to engineer. Given the existence of a more meaningful form of economic know-how, that tragedy with all the misery it inflicted on a substantial section of the human race, might well have been averted.

The second of the two events I spoke about, was of special concern to the inhabitants of the United Kingdom. It involved Winston Churchill's decision in 1925 to put the £ sterling back on the Gold Standard on the basis of the same relationship with the American Dollar as it had had on the outbreak of World War I in 1914. This is what had been recommended in the final report of the Cunliffe Currency Committee, which was largely made up of banking interests under the Presidency of Lord Cunliffe, then Governor of the Bank of England. It saw this as providing one of the best ways of giving effect to its obsession with deflation. And because this is what it did on the basis of an exchange rate that grossly overvalued the £ in the international currency markets, the impact on the economy was disastrous

It is interesting to see that when the chickens finally came home to roost with the economic crisis that culminated in the collapse of the Gold Standard misadventure in 1931, Winston Churchill apologised for his 1925 gaffe but went on to say that he had been grossly misled by people who should have known better. "When I was moved by many arguments and forces to return to the Gold Standard in 1925", he said in a speech to the House of Commons, "I was assured by the highest experts – and our experts are men of great ability and indisputable integrity and sincerity – that we were anchoring ourselves to reality and stability and I accepted their advice. We have had no reality, no stability." After describing the absurdities that had been perpetrated by this excursion into unreality with such devastating consequences, he added this, "I therefore point to this evil and to the search for remedying it as the first, the second and the third of all the problems which should command and rivet our thoughts."

What he was implicitly saying was that the science of economics consisted largely of a vacuum – a void within which dangerous and deadly absurdities could enter – absurdities that, as he put it, only had to be asserted long enough and only left ungrappled with long enough to endanger the capitalist and credit system on which the liberties, enjoyment and prosperity of the vast masses depended.

His message, in short, was that the economics shaping our lives and destinies was anything but meaningful. What kind of reaction did that challenge meet with? I can tell you that the reaction to the crisis from the cross-party coalition that had been put together to decide what should be done about it is responsible for the fact that I am addressing you this evening. For the austerity policy it launched was a kind of traditional knee-jerk response, calling not only for a 10 per cent cut in salaries but also for the cancellation of the scholarship which I had earned by getting through all my A

levels at an exceptionally early age. This would have taken me to a major university for three years and, hopefully, have enabled me to enjoy the career I had set my heart on – a builder of railways in our still thriving overseas empire. As it was, all I could get was a free place at the London School of Economics and the offer of the employment I needed for support while completing the course for a Bachelor of Commerce degree. Strange though this may seem, that course, which embraced economics, industrial law, business psychology, statistics – subjects which seemed to be tailor made for the economic world of today – was recently abandoned by London University.

I should go on to say that the aftermath of the crisis was not without compensations for me. This was because the financial pressure it imposed on the paper that had offered me a job – the Financial News, one of the two journals that merged in 1945 to form the Financial Times of today – was such that it had no alternative but to look among the apprentices for a successor to a member of the staff who had been head-hunted by a national daily for its financial column, and I found myself in the first of the senior positions on the paper that I was to hold until I was, as I described earlier, thrown out for indiscipline in 1976.

So it can be said that economics became more than a little meaningful for me in the wake of the country's flirtation with the Gold Standard disaster. But what did it do for the rest of the community? The decision to follow up the massive deflation of the British economy brought about by the Gold Standards involvement, with a huge austerity drive aimed at strengthening the Government's budgetary position, was obviously a grotesque mistake – the more so as the US authorities were at the very same time helping to poison the international economic environment with a vicious credit squeeze that the Federal Reserve Board had put into operation to deal with the aftermath of the 1929 crash on Wall Street. And that, of course, was an approach to their crisis that was just as inappropriate as the British one. Inevitably our own economy, like those of most other countries, continued to languish, with unemployment climbing beyond the 3 million mark and displaying a disconcerting tendency to stay there.

All this inevitably focused attention on the need for economic reform. One of the discoveries quickly made by those who, like Edward Holloway, began to respond to the need for new thinking, was that all too little was known about the processes that were subjecting the nations to what appeared to be a quite unnecessary deprivation. Lord Melchett, one of the country's most powerful industrialists, who took a particular interest in the role that monetary mismanagement was playing in perpetrating the disorder, hit the nail on the head when he wrote in the book he was publishing under the title *Modern Money,* "There is no economist, no banker, no financier who can give a clear answer to the questions put by a distressed and tormented world."

However, thanks to the leadership provided by Edward Holloway and some of his equally concerned contemporaries, there began to be a grudging recognition in the corridors of power that something had to be done about getting economics established on a more sensible footing. Unfortunately, their campaign met with so much resistance that, in the end, it was the advent of World War II and the powerful dose of Keynesian medicine that it injected into the patient that extricated the country from the economic crisis that had descended with the collapse of the Gold Standard nearly a decade before.

It would be broadly true to say that, while hostilities lasted, economics was more or less in a state of suspended animation. The Bank of England raised the Bank Rate from 2.5 per cent to 4 per cent on the day that war was declared and was then promptly instructed by the Government to restore it to 2.5 per cent where it stayed for the rest of the war. The strains that the need to give top priority to military activities imposed on the economy were inevitably inflicting immense damage upon it in the balance of payments field and elsewhere, but this was kept out of sight until peace returned.

Happily, the ideas of Keynes and other reformers were to influence in major degree the brave new economic world put in place when the fighting was over. The Bretton Woods institutions – the International Monetary Fund and the World Bank — which were two of the principal manifestations of the new thinking have been the subject of much criticism of the 'being wise after the event' character, in more recent years. But it is broadly true to say that the twenty five years during which the ideas that begot them dominated the functioning of global scene, saw the world enjoying an economics experience which was closer to perfection than it had experienced before or has experienced since.

There has been a tendency for the detractors of this performance to portray the partial eclipse the Fund and the Bank suffered after the opening of the 1970s as the inevitable product of a hardening of the arteries which had begun to overtake them in the 1960s. But what really triggered this change in their fortunes was nothing to do with that. What happened was that Washington found itself unable to go on insisting any longer that the dollar was as good as gold at the $35 per ounce parity built into the Bretton Woods structure. This was because of the imminent danger of the outside world's determination to take advantage of that provision to unload surpluses of dollars it had been accumulating pushing America's rapidly diminishing gold stock below the $10,000 million level considered to be America's minimum war chest. Without consulting anybody else, the President ordered the closing of the US Treasury's $35 per ounce "gold window" and thereby destroyed the sheet anchor of the entire International monetary system.

It would have been possible to think up a way of repairing this damage. But that did not happen. One reason for this is that there was little disposition in the pace-making countries in general and in the US in particular to think in these terms. Also on the scene was an increasingly influential economist lobby portraying the deregulation of everything in sight as being the greatest "good" and a "good" moreover that the world could not possibly have too much of.

With the fixed relationship between the dollar and gold gone, the International Monetary Fund's most important function – trying to ensure that the exchange rate relationships between the world's currencies behaved in an orderly fashion – was undermined. So the way had been opened for the advent of floating rates. The slide towards the disorderly way of international economic life that now characterises the global scene had begun.

It was given a powerful send-off of an entirely unexpected kind. It took the form of the sudden opening up of a great source of additional credit as a result of the oil prices

explosion in the 1971–73 period, provoked by the onset of another war between Israel and her Arab neighbours. The proceeds of the greatly inflated balance of payments surpluses the oil-producing countries then began to develop, provided the raw material for the international banking system to indulge in a mammoth spending spree, with the credit-hungry countries of the Third World as its principal target. In itself, the idea of providing these countries with additional financial support of the kind they needed to get their development programmes on the road, had a lot to be said for it. What was clearly not in their interests or even, as became apparent in due course, in the interests of the lenders, was providing them with money on a scale that was out of all proportion to their credit-worthiness and was thereby saddling them with indebtedness that they would never be able to service, let alone repay.

Considerations of traditional banking prudence having been so wilfully swept aside by institutions that should have known better, the chickens duly come home to roost. They did so in the shape of an international financial upheaval that shook many of the lending houses involved to their foundations, and forced most of the borrowing countries to accept settlement terms that put the economic growth they had so painfully achieved into reverse and are still acting as a major obstacle to their badly-needed economic advancement a decade and a half later.

That was a bad enough initial departure from meaningful economics but it was only the start. In its wake came a repeat performance of the 1970s credit creation rampage, this time with the advanced world as its target. Helping to fuel it was the onward march of deregulation of almost all aspects of financial activity. For this was adding to the quantity of money circulating in the international financial markets at a pace far exceeding that required to fuel sound economic growth. IMF figures show that the foreign assets of deposit banks – a good guide to the behaviour of the quantity of money circulating in the international financial markets – trebled during the 1980s, whereas global economic growth was clocking up figures no higher than two to four per cent per annum.

Lending excesses now became the order of the day in a wide range of advanced countries, the resultant damage now being mostly inflicted on the home front rather than abroad as in the 1970s. During the second half of the 1980s, the extent of it and its very serious nature began to emerge.

One of the forms it was taking was that of posing a major threat to the financial well-being of both the lenders and borrowers. In the case of the lenders, this found expression in their finding themselves in the throes of a liquidity crisis which, in all too many cases, called for an immediate and highly disorientating battening down of the hatches if their institutions were to survive. The excesses of the borrowers, for their part, produced an aftermath just as painful, as the behaviour of the UK's insolvency statistics from the mid-1980s onwards demonstrates all too clearly.

One of the most pertinent illustrations of the muddled thinking about control of the monetary supply that existed at this time is to be seen in the way in which Chancellor of the Exchequer Lawson suddenly found inflation rearing its head once again in alarming fashion, just when he thought he had found the perfect enduring answer to it. His solution he perceived in medium-term budgeting, with deficits experienced in periods of recession being set against surpluses achieved in periods of expansion. What he didn't seem to realise was that such "cleverness" would count for nothing if, the Government credit tap having been turned off, funds were allowed to flow in on a huge scale from the rapidly expanding global money market. This, indeed, is what it did to such effect that, by the end of the 1980s, UK inflation was moving into double figures.

This part of the harvest the nation reaped from the 1980s' deviation from the path of meaningful economics that it was allowed – indeed encouraged – to indulge in was bad enough. What was even worse was the calamitous effect it had on the sustainable growth that modern nations rely upon to keep their economies on an even keel and thereby reduce their economic management problems to a minimum. By creating a situation wherein large parts of the population eventually found themselves under the necessity to cut back consumption so they could cope with the repayment problems their over-borrowing had brought in its wake, the banking system had helped to pave the way for a recession. It was a recession, moreover, that could be counted upon to roll on for as long as was needed for people to get their finances re-established on a satisfactory footing. The 1980s' bank lending spree had turned out, indeed, to be the perfect recipe for a recession that was not of the familiar cyclical kind to which the Capitalist way of life had always been vulnerable. What we are now witnessing, with many of the world's major countries, including our own, still struggling to get the economic wheels turning at an adequate pace three to four years after they started slowing down, provides abundant testimony to what the 1980s' deviation from meaningful economics has cost.

So through the 1970s and 1980s, we were moving further and further away from meaningful economics. And the situation has certainly not improved since the opening of the 1990s. The sad reality is that it has gone from bad to worse. Manifestations that economic life is now both nationally and internationally reduced to what can be accurately defined as a shambles are staring us in the face on all sides.

To begin with, it is undeniable that the worldwide deregulation of international financial activity and the simultaneous growth of the quantity of footloose credit have locked us into a massive global money market. The consequence is severely to circumscribe the ability of each and every country to pursue the economic policies that would suit its circumstances best, which is itself bad enough. But what makes it the more worrying is that this global market is itself to a large extent in the nature of a mindless monster. No machinery for keeping it under surveillance has been put into place – let alone to bring it under suitable control. The so-called Group of Seven, which is made up of representatives from the major pace-making countries, pretends to exercise some form of discipline over it, but it is given to backing down with great expedition whenever it is called upon to face up to any really serious challenge.

Then there is the fact that the foreign exchange markets – whose activities are of such significance for the flow of international trade – are at the mercy of massive flows of speculative funds capable of producing (even between one day and the next) variations in the market values of our currencies that have little or no connection with changes in their purchasing power in terms of one another.

It is also the case that even the most elementary forms of official economic

management are becoming difficult to put into effect and, in any event, fit only where they touch so far as serving the purpose they should be is concerned. Recourse to such fiscal instruments as the manipulation of tax rates having become more and more unfashionable, the only economic weapon to speak of at the disposal of most governments is the manipulation of interest rates. But the usefulness of the influence it can exert is greatly lessened by the fact that it has to take its cue in significant degree from what is happening to interest rates in the rest of the world.

As if that were not enough, global economics now has to cope with innovations that are gaining a stronger and stronger hold on market activity of every kind as the months go by – innovations that are seen as capable, so long as they remain as completely unregulated as they are at present – of spawning a financial holocaust of the most horrendous proportions. The outstanding example is derivatives which the Bank for International Settlements, the central bankers' bank, sees as the biggest threat of all, and which the head of the US Federal Reserve has described as beyond the reach of all official regulation. If the financial markets are a minefield, wrote a Financial Times columnist recently, derivative instruments, futures and options appear to be the most fiendish of booby traps.

To add to the misery, what is becoming apparent now is that the collective effect of the onset of all these economic disorders has been to reduce the markets to a state of jitteriness of such a deep-seated character that it results in reactions of the most exaggerated kind to developments in the financial field, whether they are taking place at home or abroad. A short time back Lloyds Bank pointed out that the industrialised world is now entering a new era of sustained low inflation. That is a turn for the better of the most impressive kind in one of the major elements in the economic mix. Yet this is how a leading US financial newsletter spoke about what had happened as a result of German problems spilling over into the London market, notably by causing British Government bonds to fall to a ten-year low. He said: "Does it sound familiar? What happened in the UK was a close replay of our own nervousness. Hints, rumours, rain showers in Iowa – you name it and the market is acting upon it."

Is there any direction in which we can look for relief? It is hard to find one. Political unification to match the economic unification now becoming more and more a fact of life would help to eliminate some of these tangles, but only at the expense of generating new ethnic frictions of such a kind that it would effectively amount to jumping out of the frying pan into the fire.

If the twilight of meaningful economics is not soon to give place to night, new thinking of a very far-reaching order is going to be required. We could do with a new super-Keynes for a start. But what can already be seen as the appropriate starting point for a new economics world order is recognition of the lesson taught by the story of how we have got to where we are now – which is that, in economics at all events, you can very easily have too much of a good thing.

MERCANTILISM, A PATH OUT OF CHAOS?

By Ron Read

The ERC recently published an excellent, thought provoking, Discussion Paper "The Need for Mercantilism"*, basically a market economy constrained by some monopoly, protectionism, state regulation and import control, as a method of promoting the controlled growth of private ownership and creating a stable civil economy from the eco-social morass of post Communist Russia. There is much in Russia's past and in post-Revolution history to support, and add to, the authors' thesis.

Winston Churchill is attributed with having said that, "among the very many tragedies suffered by the Russian Empire, two stand out; the birth and, by far the greater tragedy, the death of Lenin".

The argument for the first is that without the presence, persistence, and political acumen of Lenin the Bolshevik Revolution could not have been sustained, and for the second that had he lived the USSR would have emerged as a liberal Socialist state with a constrained market, rather than a totalitarian command, economy.

The indications are that Lenin was a pragmatist, aiming for "the maximum welfare of all the people", by what ever means experience indicated it might be achieved. In 1921 when it became obvious that the Command Economic Plan, simplistically the requisition of surpluses, had failed (without the incentive of personal profit the surpluses had disappeared), Lenin became instrumental in the introduction of the New Economic Plan: basically a controlled market economy "effectively the harnessing of the Capitalist horse to the Socialist cart". In essence the plan implemented the careful restoration of private property and the revival of the Kulaks and middle class. To quote Nikita Khrushchev "It was another example of Vladimir Ilyich's wisdom and foresight. Almost as soon as the NEP was instituted confusion and famine began to subside, the cities came back to life, produce reappeared in the market and prices fell."

In the event Lenin died and Marxist hard liners under his successor Stalin imposed a policy of collectivisation and state control which led to the death by starvation of millions of the population and ultimately to the fall of communism and the chaos we see in Russia today.

In some ways the Russia of 1921 had advantages which are not present in the rump of the former USSR today. Tsarist Russia, despite its feudalism and large estates, had essentially a fragmented economy of small businesses and peasant (Kulak) smallholdings. Larger industries, from which the Revolution drew the majority of its strength, were in the minority. In 1921 this structure was still largely in place and all Lenin had to do was to provide the opportunity for profit and within two years the results Krushchev graphically describes, came about.

Unfortunately the large-unit, monolithic command economy existing at the demise of communism offers no such advantages and the solution of Russia's socio-economic problems today may be argued to be more difficult than those facing Lenin. Massive State owned industries, controlled by entrenched self seeking bureaucracies, former party members and a military which have their own particular interests to protect, cannot respond in the manner that the immediate post-Revolution, Kulak/small business economy could. In economic terms in Lenin's day the State cart might be pulled by perhaps two horses. Today the total is far greater, and getting those diverse interests to pull in the same direction is the biggest problem facing Russia's new leaders. The emergence of large scale criminality is but a symptom of that problem: arguably fragmentation could be a benefit. It might also be helpful for PR purposes if statistically two economic sectors were identified, say the Real Economy, that which creates wealth, and the Secondary Economy, that which does not, with each appropriately regarded and rewarded as incentive for personnel to graduate to the former and fear return to the latter.

Lenin's masterly handling of the State and comrades during, and following, the Revolution; his use of fear, carrot and stick; ability to play one individual or faction off against another, indicates he was aware that, apart from a small altruistic minority, all aimed to maximise their own personal interests, by position or profit, within the Revolution. Acceptance of that precept, whether it be in controlling the State, or the enterprise needed to support it, must be the biggest single tool in the creation and maintenance of the Civil Society necessary to keep Russia from lapsing back into the despotism that characterises her past and threatens her, and by association the world's, stability and future.

The cult of the leader, whether it be Lenin, Stalin or the Tsar, is grounded in the Russian psyche, explaining to some degree the current threat, from potential despots, against progress toward the Civil Society. The ERC Discussion Paper quotes Lt Col Petrovich "The economic situation is the biggest reason (for the huge rise in crime) ... That, and the collapse of ideals. The old ideals are gone – but there's no new morality." The apparent lack of ideals is a criticism often aimed at capitalism. In the latter context Russia would seem ill advised to jettison the long dead pragmatist Lenin, a potentially invaluable legend who, appropriately used, might contribute much to the restoration of the ideals and morality which Lt Col Petrovich mourns.

There is much in recent Russian communist propaganda/revisionist history to enable Lenin to be presented as a pragmatic visionary leader, cut short in the prime of life, who came to believe that socio-economic justice might be achieved through use of the free market: the, Nikita Krushchev and others', critique of Stalin gives historic foundation for such an interpretation and a powerful impetus to the use of Lenin as a figurehead, a focus, imparting a much needed feeling of continuity, to the Russian State and people, while implementation of the democratic change takes place.

Albeit poor in cash terms, Russia is rich in capital, having massive assets; oil, gas, minerals, vast fertile lands, scientific and technical expertise, a large well educated population; all mortgageable in investment terms, if properly presented. In a fast changing world economy where most emerging nations are industrialising, fighting for markets, working harder and harder to produce more and more for less and less, putting

* *The Creation of a Civil Economy in Russia, the Need for Mercantilism*, by Tony Baran and Robert McGarvey. 1993. Price £2.00

the very wisdom of joining them in question, Mercantilism, as an option for a large country with Russia's capital advantages, offers the opportunity to develop a competitive internal economy and just enough external trade to stimulate native suppliers and keep the import/export account in surplus. The indications are that Lenin would have found such a solution acceptable, even though democracy would have been unlikely to have become an element during his lifetime.

OUR ERC – SOME INFORMATION NOTES

By Jim Bourlet

Background

- ERC founded as "The Economic Reform Club" in 1932 and changed to "The Economic Research Council" in 1941.
- Membership has been as high as 1000 but is currently around 350. Members are drawn from political life, from academia and from the business world.
- The role of the ERC has always been to use its journal (formerly the "Economic Digest" and currently "Britain and Overseas"), its Occasional Papers and books and its dinner meetings for the purpose of developing ideas for the benefit of the general public, keeping members abreast of current developments and of influencing the political debate on issues of economic concern.
- The ERC has never supported any particular political party or economic doctrine. During the 1930s and 1940s the ERC certainly promoted ideas associated with J.M. Keynes but since that time has been largely sceptical on any doctrine.

Current Policy Position

Most policy groups are identified with particular general solutions. Thus the IEA with "market mechanisms", the Fabians with "socialism", the Georgists with "land value taxation" etc.

The ERC prefers to start with identified problems and to develop strategies in response. Thus:

1. The problem of economic growth during the 1960s led to the publication of the ERC's "Economic Recovery Programme".
2. The problem of money supply and control has led to a number of publications of which recently there have been "Reflections on Money" edited by David T. Llewellyn, and "Towards True Monetarism" by Geoffrey Gardiner and Christopher Meakin.
3. The problem of unemployment has led to a number of ideas and proposals. The ERC has been suspicious of the official figures on unemployment and has tended to support market mechanisms rather than general reflation in recent years. Recently the notion of reducing the cost to the unemployed of taking work by allowing them to keep all or part of their unemployment pay – possibly via a negative income tax scheme, has received some attention.
4. The problem of EU inefficiency and waste, to say nothing of its political ambitions is often commented on and the ERC is delighted with the latest work on this subject by ERC member Bill Jamieson in his book "Britain Beyond Europe".

5. The problem of poor growth performance by Britain's industries has led in recent times to general support for Privatisation and for a renewed interest in the need for the state to pursue policies which nurture growth industries. For us this probably now means assisting service sector industries but the ERC was pleased to publish (with Paine Webber) a pamphlet commenting on developments in Russia entitled "The Creation of a Civil Economy in Russia: The Need for Mercantilism" by Tony Baron and Robert McGarvey.
6. The problem of developing a view of Britain's role in the world – her place within the world economic framework, is a recurring theme. For example, the ERC submitted evidence to the House of Commons' Select Committee on Trade and Industry in 1983 on Britain's trade relations with the EEC. There is a danger of any such reasoning looking *backwards* to bye-gone relationships, supporting *industrial* specialisation whereas the evidence around us suggests that Britain is more likely to develop *services* effectively. We are exploring the notion of Britain being yet more concerned with such areas as education, health, entertainment, information, finance and tourism.
7. It is felt that there *is* a problem, largely unaddressed elsewhere, of finding ways in which a high proportion of the population can acquire a stake in ownership and wealth. This should be a subject of further research and should be linked to the question of unemployment.
8. The problem of inner city decay is a recurrent theme. A recent talk was entitled "Garden Cities and Sustainable Growth". The ERC would like to go further towards the idea that the inner cities should be major growth points for the economy. Inner cities should be wealth creating rather than wealth consuming economies.
9. The ERC is proposing to study Government monetary and fiscal policy which over many years has resulted in a high interest rate, high capital cost, economy, penalising growth across all industrial and commercial sectors, compared with our major competitors, Germany, Japan and America.

DO DIVIDENDS HINDER NEW INVESTMENT AND JOB CREATION?

By Alan B. Parker

There has recently been some debate over dividend levels and the potential benefits from reinvesting a greater proportion of profits into businesses. A separate but not unrelated topic of discussion has been the rate of return which should be sought from new investment into fixed capital, i.e. the likely profitability of projects which are under consideration. On the one side we have those who favour high distributions, whilst on the other, their opponents argue that retained profits would lead eventually to still higher returns, by improving the working capital of companies. This in turn, it is claimed, would increase investment and thus create jobs. Seekers of "Green Shoots" of recovery might be encouraged by the development of this debate as without an expectation of profits, the discussion would be purely academic.

The case for dividend freedom

Three arguments are generally put forward to support high levels of dividend distribution:

1. Pension Funds and insurance companies need the cashflow to meet their obligations, both current and future.
2. Profits belong to the shareholders and in today's soft tax regime, it makes sense to withdraw as much as possible.
3. Dividend cuts leave companies vulnerable to take-over as they often cause a drop in the share price.

The first reason quoted, that the requirements of institutional shareholders must be respected, is valid enough but the second and third lines of reasoning are less compelling. These three main arguments in favour of high distributions are in any event simplistic, and when they are opposed by a senior member of the government, it is advisable to at least consider the alternative point of view held by those who advocate greater retention of profits within companies.

The case for restraining dividend payments

Owners and management must think beyond the next dividend payment if a company is to compete and prosper, argue the "restrainers". Perhaps it is no coincidence that our successful competitors overseas typically retain a larger part of their profits and often have substantial long-term (and satisfied) shareholders. The "total return" (i.e. income plus capital growth) enjoyed by domestic investors, could well *increase* if dividends were reduced to conserve cash balances. There are several reasons claimed for this, beyond the obvious saving in finance costs or increase in deposit interest:

1. Better ability to survive any downturn in trading;
2. Research and development can be maintained or stepped up,
3. Modernisation and/or expansion is facilitated and
4. Stock levels and debtor balances can be adjusted upwards if appropriate, with less strain on cashflow.

In considering the claimed effects of lower dividend levels on new investment in British business, it is perhaps also relevant to ask how so many corporate balance sheets have fallen into such unhealthy condition. Many company chairmen have blamed the recession for difficulties which have their origins in a lack of prudence during the "Boom Years" of the 1980s. An excessively liberal dividend policy *may* be one reason for cashflow problems, especially if it is aggravated by poor trading conditions, bad debts and the generally more demanding environment of recession. Different companies, at different stages of their life-cycles, have their own cash requirements, and some British businesses have suffered from milking by greedy shareholders. In confusing profits with available cash balances, directors have on occasion over-distributed and have weakened balance sheets, rather than setting aside sufficient revenue reserves. In short, claim the proponents of restraint, the short-term view has prevailed over sensible regard for the long-run future of their companies.

Dividends and Democracy

The second plank of the case against restraint, particularly if it were backed by legislation, is that a company and its post-tax profits belong to the shareholders. Surely no Conservative Government would introduce an effective incomes policy for investors? One can imagine the impact on corporate political donations to any party which attempted to introduce statutory limits. The problem here is that too few private investors act and think like minority owners of the businesses in which they invest. Annual reports are briefly glanced through, voting cards not completed, no real interest taken other than in the prospect of a quick and easy profit. Until recently we had the Business Expansion Scheme, which offered higher rate Income Tax relief on eligible shares and freedom from Capital Gains Tax, subject to a minimum holding period of five years. Perhaps a similar exemption from C.G.T., on long term investments would encourage a more stable and considered approach by the private shareholder.

Dividend policy and Directors' job security

The least convincing argument held out against dividend restraint, is the reluctance to cut the payout when profits fall, for fear of attracting a take-over bid. The payment of unjustifiably high dividends to deter predators is still quite widespread and, again, will not be resolved by legislation; the answer lies with shareholders. I have mentioned the apathy of many private investors and it is still rare to see an Action Group formed to

oppose an incompetent Chairman or Board of Directors. The appointment of Non-Executive directors does not seem to have any great impact, with only the slightest drop of new blood coming into our Boardrooms. More often than not, disgruntled shareholders understandably sell out before their share price falls further, rather than taking to task an unsatisfactory management. When a company is clearly in deep trouble, a potential bidder might prefer to wait until he can deal with the receiver, as we saw in the G. E.C. purchase of parts of Ferranti. All too many "hostile" bids are decided by shareholders watching day-to-day price movements, rather than assessing the prospects some years ahead, but the take-over market is quite often an effective agent for the removal of poor management, albeit a blunt investment. Where bad management is contributory to a reduction in dividend, shareholders might welcome an offer from someone who feels better able to run the business.

But how much difference would dividend restraint make?

The implied link between dividend restraint and increased employment, demands consideration. Businesses do not save for specific future expenditure; reserves more often are set aside to support the balance sheet against the impact of inflation. Even when a company has built up substantial revenue reserves, it might well need to call on shareholders for fresh capital to finance planned expansion. In practice, a rights issue is often the only available means to meet the cost of an acquisition or major new capital expenditure, whilst keeping shareholders' funds in balance with assets employed. The flow of new capital is always towards perceived profitable ventures, and each new issue of equity is judged on its merits. A reasonable initial yield must generally be offered to subscribers, as a tangible incentive to increase their stake in the company, when existing shareholders are asked to finance new investment by a rights issue. However, many enterprises have raised funds despite specific warnings that dividends would not be paid for some considerable time – North Sea oil exploration and development was partly financed on this basis, and more recently Eurotunnel and Euro Disney raised millions for "cold start" projects. Risk and reward were balanced by potential investors who made capital available, in the belief that there was a reasonable likelihood of good returns in the future. Without any doubt, private funding would not have been forthcoming if these speculative issues had been floated against a restriction upon the amount of eventual profits which could be paid out as dividends. Moves towards restraint (a euphemism, perhaps, for statutory limitation or reduction) in payments would deter rather than foster capital-raising for new investment.

So what is impeding job creation through new investment, if capital can be obtained?

Any mandatory restriction e.g. a call for dividends to be twice covered by net profits, would be inappropriate for a large part of British business. Each company's dividend payment is influenced by its own situation in terms of working capital requirement, expansion plans and the nature of the business with the overdraft often increasing during a period of greater profitability as stock, work-in-progress and debtors build up. Good management who know their business, will generally declare dividends which are fair in the circumstances, and increased profits will in due course allow of improving payments to shareholders. Capable managers calling for additional capital to finance viable projects, can usually find support in the Stock Market or from Venture Capitalists.

Boards of directors and shareholders consider opportunities for new investment, in the light of projected interest rates, inflationary trends and rates of exchange – an equation full of variables, any of which can mean the difference between handsome profit and disastrous loss. A "hurdle rate" is applied to test the profit potential against these risks – the greater the perceived uncertainties, the higher the hurdle. Potential investors also assess the risks involved and they require an acceptable return, before they will move funds from safer deposits or Government Bonds. In effect, they set their own "hurdle rate" albeit usually less precisely than the industrialist with his computer models. The Governor of the Bank of England recently called for increased investment, but almost at the same time warned of inflationary pressures and cautioned that interest rates might need to be raised. What better a reminder to industrialists, that allowance must be made for these variables? And who can blame them for assuming that current conditions are cyclically favourable, and will not last?

A major new project or acquisition will be expected to pay for itself in many cases in as little as three years, and only rarely in more than five years. However, our overseas competitor viewing a similar project against a probability of stable currency and interest rates, low inflation and a mobile workforce, might be prepared to accept a pay-back period of eight or ten years. Consequently, the British company rejects a scheme and jobs are created overseas; eventually the new project will take business from the outdated and ultimately, British jobs are lost.

It is also important to remember that there is in fact only a loose connection between investment and job creation and *new capital expenditure will often destroy jobs.* The installation of robots into a production line, or even a farmer's purchase of a combine, may lead to redundancies. In many instances, investment is specifically intended to cut wage bills. Labour costs and pension contributions are typically over half the total production costs of UK manufactured goods; most technological investment is designed to either a) increase unit output per worker or b) reduce the number of employees required to achieve a given level of output.

"Give us the tools and we will create the jobs"

Long term stability is the key; and for this, the institutions and industrialists can only look to the Government. A generous dividend payout is probably far less damaging to a company than the cumulative effect of years of "Stop-Go" economic policies, volatile currency and exchange rates, and the occasional experiment such as ERM membership. The prosperity of Swiss industry in particular, is testimony to the benefits of a stable business climate, rather than to any peculiar pattern of share ownership, or the Swiss habit of amassing reserves to reduce corporate taxes.

Good Government – of any colour – should provide the framework in which enterprises can prosper, for the benefit of owners/shareholders, employees and customers. Shareholders will only accept dividend limitation if it is balanced by improved capital growth prospects, which are provided by a favourable business climate. But increased investment does not always bring lower unemployment, and incentives might be required to encourage truly job-creating projects. Capital allowances, grant assistance and relocation payments can provide an important stimulus where genuinely fresh employment is envisaged, and it is vital that central funds be kept available for this purpose. Merely limiting the dividends paid by established companies would make no significant difference to a problem of such magnitude; if there is to be any criticism of excessive payments, then it should be of Boardroom remuneration rather than the distribution of profits to the owners and risk-takers whose capital supports each enterprise. When Treasury Ministers condemn high dividends, this seems to be a smokescreen to cover the failure of their own policies.

THE CRACKED CORNUCOPIA

By Robert H.S.Robertson.
Published by the Resource Use Institute Ltd., Dunmore, Pitlochry, Perthshire. £20

This is a wonderful, creative and enjoyable book – anything but boring or limited. It is innocent fun, a challenge, and deeply thought-provoking. And it makes an unusual and vital contribution to matters of central concern today – the challenges of unemployment, devolution and taxation.

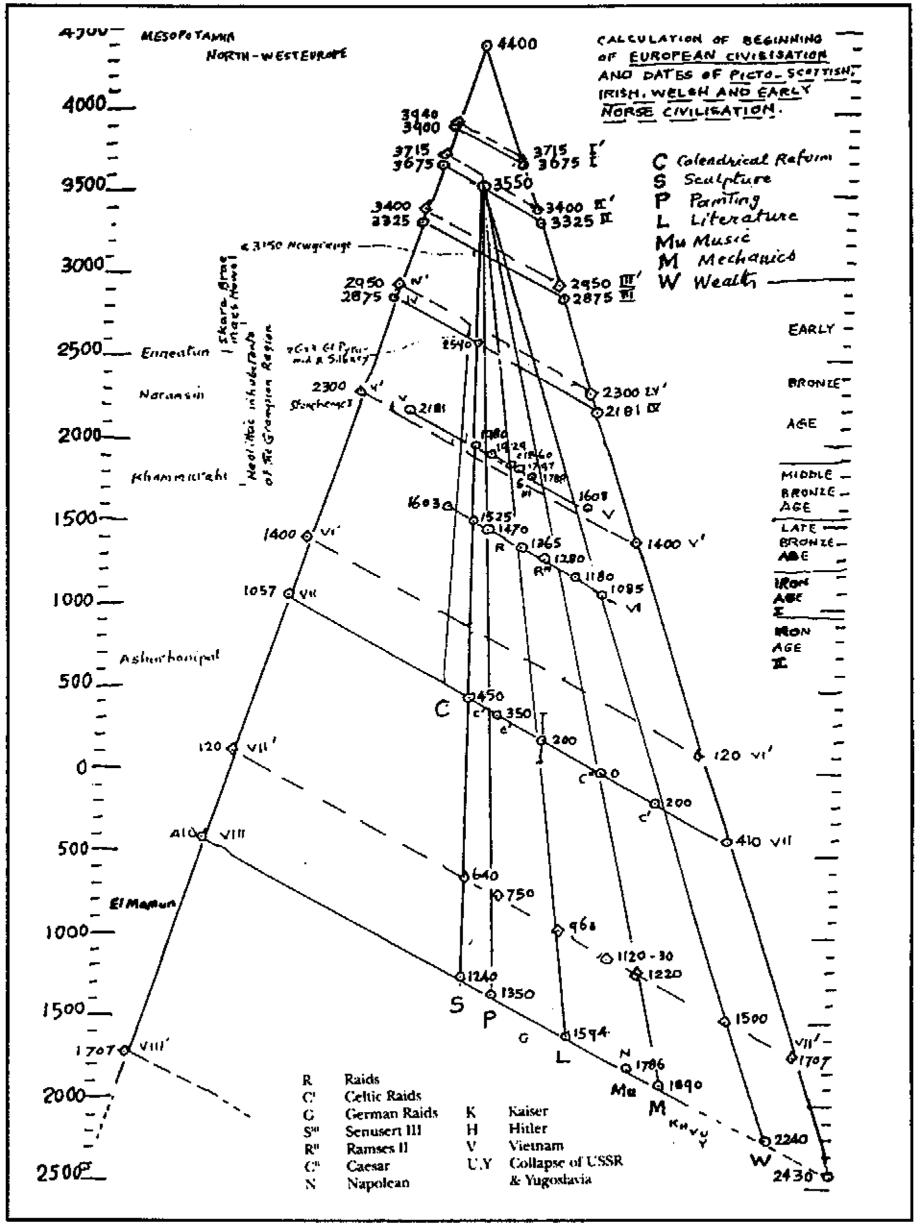
The book begins with a set of concepts aimed at summarising very long historical patterns – work based on the ideas contained in a book by Flinders Petrie entitled *Revolutions of Civilisation* written in 1911. These concepts are summarised in the figure. Each 'civilisation' is found to pass through stages of success in sculpture, then painting, then literature, then music, then mechanics and then wealth. Each starts from a 'dark age' and each ends in a 'dark age' which provides the starting point for the next 'civilisation'. Each new civilisation takes longer to pass through this series than the previous one - hence the cone shape of the figure. Our present 'civilisation' is given by line vii which began in 410 AD and will return to a dark age around the year 2430. The Roman 'civilisation' dates from the start of its dark age around the year 1057 BC and ended around 410 AD. Petrie and Robertson hold that this pattern holds good for all previous 'civilisations' and that the whole picture shows a remarkable, uncanny and exciting regularity.

Of course there is something very subjective about the dates chosen to represent the 'peaks' of each stage. The authors have judged the year 1240 to be the peak of sculpture in our 'civilisation' and the year 1786 as the peak of musical achievement etc. All one can say is that this aspect of the book seems well researched, is presented fairly convincingly and seems reasonable enough in the light of the arguments given. Anyone who now listens to "Top of the Pops" would be fairly easily convinced that we have at any rate *passed* our peak of music! And the book, rather than this reviewer, must make the case for 1890 as the peak of mechanics – rather than (say) the date when men arrived on the Moon.

On this basis we will come to a peak of wealth in the year 2240 and then rapidly decline into a new and awful dark age.

But wait! Robertson has noted two possibilities which can help us avert this fate – not an easy task given the genetic and memetic programming that has repeated the cycle half a dozen times, over as many millenia.

Firstly he suggests that in recognising this pattern, this series of 'cycles' which make Kondrattief look like a very short 'short-termist', we can study the process of change and apply corrective measures. This is the point at which tax reform, minimum incomes, national basic payments, land value taxation, energy taxation and so on enter the picture. Environmentalists, demographers, economists and ecologists can all take delight in the roles assigned them in averting catastrophe. There is much here to interest ERC members, in particular, the sections on currency reform (local currencies are to be



encouraged – it seems a pity that the author was unable to comment on the currently fashionable LETS schemes) and the notion, taken from *Peoples' Capitalism* by James Sacra Albus (1976) of a National Mutual Fund so that all adult citizens can receive dividends to supplement earned income – which can then, if necessary be low enough to compete with workers in poorer countries.

Secondly, the author suggests that the peoples on the fringes of Europe – the Scots, the Irish, the Swiss, the Welsh, the Norwegians, Icelanders and Danes etc have been out of step with the rest of Europe – maybe for at least 4000 years. This is represented on the figure by the lines marked V', VI', VII' and VIII' (as contrasted with V, VI, VII and VIII) These Celtic, pre Celtic and Norse peoples are about six centuries ahead of the rest of us – reaching their latest dark age in 1707. Whilst we are in for a fall, they are beginning the long climb back to the starting rung of a peak of sculpture – though that may still be a century or two away yet. The key to speed here will be self-confidence, self-government and opportunity. At this point the book displays a sad naivety in believing that EU membership will make all this possible. For the moment let us simply say that the EU has its own agenda!

Nonetheless, the point can be well accepted. If Europe is two "Civilisations" and one can rejuvenate the flagging efforts of the other, we can all be eternally grateful. Personally, this reviewer is under the impression that the author's point here *is* valid but it needs a good deal more thought and consideration before becoming the basis for political change.

J.B.

LETTERS

A response to "Our entry into the ERM – was it folly?"
By the Rt. Hon. Sir Peter Hordern

Sir,
The answer to Sir Peter Hordern's question "Our entry into the ERM – was it folly?' is yes, folly forced by political considerations in spite of economic portends.

The Heath government floated sterling in June 1972 – against its will and after attempting to avoid this U-turn by increasing interest rates. It was one of the very few good decisions that government made.

Eighteen years later the heady steam of Euro-political correctness, the Madrid ambush and Euro-philia of the Foreign Office made entry difficult, if not impossible, to avoid. Sterling's entry, in October 1990, was one of the few bad decisions of the Thatcher years.

'Something had to be done' writes Sir Peter. Ugh! 'That was when we joined the ERM.' Exactly.

I dispute Sir Peter's assertion that 'Nobody could have foretold the effect of allowing the Ostmark into the DM one for all.' The consequences were blindingly obvious – a major political objective was to be purchased through economic and monetary dislocation.

The suggestion that 'we should have come out of the ERM and rejoined it at a lower parity, say 2.6 DM' is unreal. Governments abhor devaluation. It represents a failure of policy, a loss of credibility and prestige. It was about the last thing that a new, nervous government – recovering from a palace revolution – would do from choice.

Those like myself who do not believe that you can buck the market anticipated sterling's ejection from the ERM.

Two years later the massive distrust which exists in the UK amongst businessmen, consumers, home owners regarding the government's economic and monetary policy derives from the absolutism with which it committed itself to the straight-jacket policy and the consequent breaking of its word.

Richard O'Sullivan
Parkgate Farm
Little Clacton
Essex CO16 9QQ

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.

SUBSCRIPTION RATES

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').
Student members	£10 per year
Educational Institutions	£40 per year (for which they may send up to six nominees to meetings and receive six copies of publications).

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
(delete those non-applicable)

Individual membership (£25 per year)
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 ....