

MONEY AND PRICES

MONEY AND PRICES

A SHORT EXPLANATION OF THE
MONETARY SYSTEM, AND SOME PRO-
POSALS TO RESTORE AND MAINTAIN
PROSPERITY BY THE REGULATION
OF PRICES AND THE RIGHT USE OF
CREDIT BY

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“Speaking o’ money,’ said the night-watchman thoughtfully, as he selected an empty soap-box on the wharf for a seat, “the whole world would be different if we all ’ad more of it. It would be a brighter and a ’appier place for everybody.”

“An Odd Freak,” by W. W. Jacobs.

PREFACE

THE purpose of this book is twofold : to explain the elements of monetary theory for the reader unacquainted with the subject, and to inquire into the causes of economic depressions in order to disclose the remedy. It also endeavours to show that the remedy advocated will accomplish more than the mere prevention of slumps.

These varied and ambitious aims would hardly have been attempted in one short book prior to the last twelve years, and the justification for so combining them now lies in the rapid increase in the number of people who, knowing little themselves concerning the technique of money, are none the less persuaded that defects in our monetary system cause the major economic evils of our time. These people desire both to learn the unquestioned facts and to be guided in judging the much disputed theories and conflicting proposals put before them. Though from the beginning the book takes the form of a fairly continuous search for causes and remedies, and thus is never far from controversial ground, I have striven to ensure that the facts as they are presented in earlier chapters are undistorted by the proposals to which they lead.

The task is easier than it would have been when I first contemplated it, some ten years ago. My views on the problem have not essentially changed since then, but have been clarified by the researches during

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that period of our ablest economists. It is true that the remedies these writers propose, when they propose any, are extremely mild compared with the ills they have to cure, and this may explain to some degree why certain more radical, if less well-equipped, reformers are disposed in their enthusiasm to dismiss the academic and professional economists as having nothing to contribute to the subject worth attention. But no serious inquirer into economic theory to-day can afford to ignore the works of such writers as Mr. R. G. Hawtrey, Mr. J. M. Keynes, Professor Pigou, and Mr. Dennis Robertson, not to go outside our own country. To these I gladly acknowledge my own indebtedness.

The quotation, a page or two back, from Mr. W. W. Jacobs's very human night-watchman should not lead the sophisticated reader to assume in advance that what is here advocated is merely an inflation of credit or currency. I hope, too, that the emphasis laid upon the influence of bank credit, and the concentration in earlier chapters upon its nature and effects, will not induce the presumption before the rest is read that this book attributes our economic disorders solely to the action of bankers, and looks for the remedy in the control of credit alone. The regulation of prices is the dominant need; the public control of credit is necessary too, but not as an instrument by which to control prices.

The suspension of the gold standard produces a situation very favourable to the adoption of the proposed measures.

AUGUSTUS BAKER.

LONDON,
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CHAPTER I

AN OUTSIDE VIEW

WRITERS who unfold their views of society in the form of romances have created a type of human being whose merit lies not so much in a superiority to ourselves as in his perfect ignorance of our institutions. This enables him to perceive the strangeness in them to which we, through familiarity, are blind. He is normally portrayed as a creature without guile, and prone to ask simple questions that confuse and perhaps annoy us. But this guilelessness and simplicity have their uses to the critic of our institutions, who can endow his hero with far more detachment and freedom from party feeling than any modest critic would claim for himself.

For a few minutes, in the hope that he may assist us to survey our problem, let us bring one of these Utopian gentlemen into our midst. We will call him Socrates, and suppose him to have toured our civilised world during the year 1930, learning as much in that time as we may require him to know for the sake of argument. He has just spoken of the vastness of our towns, the amazing productiveness of our machines,

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and the variety of goods and services that we enjoy. "But so many of your people," he adds, "look tired and anxious."

"They are poor," we tell him.

"You mean, then, that the earth is not fruitful."

"No, we do not mean that. The earth is fruitful enough, and could be made more so. True, we fail in this country to grow enough food to maintain all our people, but other countries grow more than they need, and exchange their surplus for articles we make with our machines, and for other services we render them."

"Then do you mean that those machines, wonderful though they seemed to me, cannot produce enough articles to exchange for as much food as you want? Or do you mean that, having given up all the articles you make in exchange for food, since food you must have, there are none left for your own people?"

"No, Socrates, we do not mean that either. Our machines are quite as wonderful as you suppose. Let them be set to work with but reasonable continuity and they can make more than enough goods to buy our food and supply the needs and comforts of our own population as well."

"They can do so, but they do not," says Socrates. "That is what I infer. And the reason why they do not must be because there is a famine in the woods and minerals and earths and so forth out of which the machines make your goods. Or, perhaps, the famine is in the fuel from which your machines derive their power."

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“There is no famine in any of these things,” we reply. “Those who grow them or mine or quarry them often have such vast quantities that they cannot easily get rid of them, and conspire to restrict their output.”

Socrates ponders. “It cannot be,” he says, “that your people are lazy. For the periods set aside for work each day are far longer than my people work. Neither do I see so many playing games or enjoying public holidays as I am used to. True, there are numbers who seem idle; but their idleness does not resemble that of men who have worked with a will and now take their ease. Rather it resembles the idleness of men who are ill.”

“They have no work to do.”

“That I can well understand, since it appears so easy for you to satisfy your material wants; but why these men who are thus released from labour look ill and unhappy I do not understand. Tell me, however, this world of yours having food enough for its needs, and an abundance of other goods, wherein are your people poor?”

“In money,” we tell him.

“In money!” cries Socrates, and is manifestly puzzled.

“Is the use of money unknown to your race?” we ask him.

“By no means. Yet I cannot see how a people can be poor in money and rich in everything else. It would be inconvenient.”

“It is certainly inconvenient.”

“Why do you so inconvenience yourselves?”

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“Is money, among your people, a trifling thing, Socrates?”

“It is a great convenience, like the art of printing, or co-operation in carrying out large works, or appointing a committee to make plans for some project in which many citizens are concerned. Having shaped these devices, we should be foolish not to use them as often as they can aid us.”

“And the application of what you say to money is that we should create as much of it as we need?”

“Surely that is evident?”

“Let us see first what it means. From what you say of money it is clear that you use a kind which is easily and cheaply produced. It is not made of a material that is rare and precious in itself and hard to obtain.”

“True. It is made out of a pulp produced from certain grasses and soft woods which grow in abundance. It has no value apart from that given to it by the State impress.”

“Did you always use money of this kind?”

“No. The primitives of our race exchanged goods for goods.”

“We also once could only exchange by barter. But when, for convenience, we began to use money, we made coins out of a very rare and precious metal called gold. People greatly desired this metal. Goldsmiths fashioned it into beautiful shapes, and rich men decorated their persons and their palaces with it.”

“And they exchanged this precious metal, I suppose, for food and clothing and furniture and all the other goods that men need or desire. But that is barter.

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If that is how you exchange goods, you have hardly learned the use of money."

"We do not confine ourselves to that method now. But is such a system really a system of barter? Our economists do not, I think, so regard it."

"Wherein does it differ?" Socrates asks.

"First, the gold used for money is cut into coins of convenient shape, and certain symbols denoting their value are impressed on it by the State."

"By cutting it into shapes, is its value for other purposes destroyed, then?"

"Not at all."

"And is the exchange value of the coins, as declared by the symbols they bear, determined by their weight, or can any value be placed on them?"

"The value is determined by their weight—and the weighing is performed with minute care. A sovereign, for example, weighs exactly double half a sovereign."

"Then the expressed value of the coin," says Socrates, "is merely a way of declaring its weight. When I give you a sovereign I say, in effect: here is a piece of gold declared by the State to weigh five scruples, or whatever it may be. Give me for it as much of your wares as such a weight of gold is worth."

"That is true, Socrates. Yet most of us nowadays would regard a gold coin merely as a means of exchange. To the goldsmith, and the dentist perhaps, it has a use value as well. The majority do not want it apart from what it can be exchanged for."

"Neither does the farmer want the sack of corn that he exchanges with the tanner for leather or with the brewer for ale."

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“ But the brewer, having exchanged his ale for the farmer’s wheat, consumes the wheat, I imagine. He does not accept more than he can consume, in order to exchange it with the smith for iron or with the potter for pots.”

“ True ; there is a distinction. But is it not a great disadvantage to use a valuable material for money, instead of applying the virtue it possesses to industry or art ? And does it not make it difficult sometimes to accommodate the quantity of money to the requirements of trade ? ”

“ Undoubtedly it would, Socrates, if we confined ourselves to gold, or any similar precious substance, but we do not. Although gold still plays a strange and important part in our monetary system, we no longer use it much as coinage. We have, for example, money made of paper, cheap to produce. And our bankers have improved even upon that. By far the greater part of the money we employ is represented by figures in their books, and we transfer it to each other by giving our bankers written instructions on printed forms. It is made very easy for us.”

“ Then, indeed, I am at a loss to know why many of your people are poor.”

“ One thing I notice you do not suggest, Socrates. That is, that most of us are poor because a few are excessively rich. It is declared by some here to be the explanation of our poverty.”

“ Whether your rich are excessively rich I do not know, but that cannot explain the poverty of the rest ; for what I saw of the vast productiveness of your machines you have confirmed ; yet you say they

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could produce far more. Therefore your rich do not exhaust your wealth ; they could remain rich and still the rest need not be poor. Unless, indeed, the rich are monsters, and your poor are slaves whom they compel to work without reward to satisfy a wicked lust."

"As much as that would be said of our rich by some ; and though we may ignore such statements, there are among our richest citizens many who would not easily surrender the power in the State imparted to them by the poverty and dependence of the poor. Yet their demands for material goods by no means embarrass our industries. And it has also been shown that, were their riches taken from them and all incomes divided equally among all citizens, each family would receive little more than the earnings of one of our skilled craftsmen in regular employment. But I notice, Socrates, that you seem to think always in terms of goods. Again I ask, is money so trifling a thing to you ? Tell us this before you go : has your race never experienced difficulties due entirely to the use of money ? "

"Yes, but you must ask my friend Thucydides about that. All I can say is that, long ago, some years after the use of money became established, certain strange things were observed which much puzzled our guardians. Thereupon seven of our wisest men conferred ; and it is said that they sat in conference for no less than three hours before they perceived the right measures to take."

"We have no wise men as wise as that. They reached, I suppose, conclusions as to the proper relations between goods and money."

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“ That would be their first inquiry.”

“ And what conclusion did they reach on that point ? ”

“ One almost too simple to be mentioned : that the amount of money must be sufficient to buy all the goods that we produce.”

“ Which means,” we interpret, “ that the price of all those goods must be no higher than the amount of money available to buy them.”

Socrates assents, and we continue : “ There are some among us who say the same thing, and attribute our economic troubles to our failure to realise its truth.”

“ Do you mean,” asks Socrates, “ that your money, though you have learnt to produce it at next to no cost, cannot buy all you produce ? ”

“ Whether it can or not, its amount is certainly not regulated by any principle which recognises that as its sole function.”

“ What other function it can have I am unable in my ignorance to perceive. But if there is one, it might require the amount of money to be either less or more than is sufficient to distribute your produce. But less money, we have agreed, would be inconvenient, and more would be useless. For it is useless to create money where there are no goods.”

“ Our own industrialists would say, rather, that it is useless to create goods where there is no money.”

At this Socrates regards us in astonishment, then laughs loudly, and goes away laughing. No doubt it is a great joke to a Utopian. But the humorous aspect is not the most obvious to the rest of us, who,

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as individuals, know that when money is absent from our pockets no satisfaction is obtained because goods are plentiful in shops, and, as citizens of a state, have watched political crises and international alarms arise because a nation's budget requires a hundred million pounds or so at a time when there are idle machines and two million idle men whereby goods to the value of the deficiency could be created in a month or two with the greatest ease. Neither can we feel amused to find ourselves so much at our wits' end that what is called economy, taking the form of reduced incomes and curtailed consumption, can appear to be a remedy for a surplus of goods.

Had Socrates stayed a little longer he might have asked what does regulate the amount of money circulating among us, if the total price of the goods available for it to purchase is not the determinant. We should have replied that money is expected to maintain some sort of quantitative relationship to gold.

"Then you are poor in money, you mean, because you are poor in gold," he would have said; and this might seem on the surface a not unreasonable explanation. But if Socrates crossed the Atlantic, and there found a country with more gold than ever it possessed before exhibiting precisely the same spectacle of unemployed men, idle machines, poverty, and undistributed goods as he saw in the country wherein gold was scarce, he would have required further explanations. These we must attempt to supply without his assistance.

CHAPTER II

AN EMBARRASSMENT OF WEALTH

IN reviewing our resources to discover what we might lack, the gentleman we called Socrates grouped them into food, raw materials, fuel, and manufactures ; and it will be agreed that there must be something strange about any poverty that is not signified by a shortage in one or other of these categories.

A race that finds food scarce and hard to get knows poverty in its severest form. Such may have been the lot of mankind at an earlier age, and may be still in certain regions. But taking the civilised world as a whole there is no food shortage now, and even the most fearful of those who predict such a shortage do not think it yet in sight. Either they mean that the population is increasing at a greater rate than the cultivation of food, and that something should be done to one or the other to alter the ratio, or they mean that their own particular country, through not producing enough food for its needs, is at the mercy of others in wartime.

There may be excellent reasons why English farmers, for example, should be encouraged to restore to wheat cultivation the vast acreage they have transferred to

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other uses in the last ten years ; but among these reasons is not any difficulty in finding countries able to supply all the wheat we want. Several countries compete for our orders, much to the disgust of Canadian and American exporters, who have attempted to raise prices by holding up stocks and creating an artificial scarcity. They have not succeeded simply because the scarcity has never been felt. Wheat is grown over a wide area, and somewhere or other there is always plenty for the immediate market. By growing more than is required of its most necessary commodity the world has created a problem that an international conference had to be called to discuss.

Wheat does not stand alone among foods in this abundance. Many tons of meat have been destroyed in quite recent years : because it could not be sold quickly enough, according to one explanation ; in a deliberate attempt to raise prices, according to another. Yet the butchers' shops have not been depleted. Dairies are equally well supplied, and the regulations requiring foreign produce to bear distinguishing marks were imposed less to afford guidance to housekeepers than to give the dairy farmer whatever benefit he can derive from the real or supposed superiority of British produce. He needs all the help he can get because we are not dependent on him ; there is plenty elsewhere.

Market gardening does not pay well in the commercial sense. A man who likes it may, by much hard work, supply his home with fresh vegetables and fruit, and have some left to sell. As a business, a market garden must be very skilfully and economically

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run to yield a profit, and the gardener must not set too high a price on his own labour. This, once more, is evidence of competitive selling, that is, of abundance. A particular crop may be scarce through disease, a more general shortage may occur through drought; rarely is there any approach to widespread famine.

We are not discussing the question of whether British agriculture, for social or political reasons, should be aided by fiscal means. All that concerns us here is the economic fact that the world is at present able, and will be for a considerable time, to feed its population. But a race may have food enough and still be poor in less vital goods. Are we in that position?

Early in 1930, before the depression of that year was far advanced, the City Editor of a London newspaper wrote: "Everyone of high authority in banking, economics, and industry admits that the universal slump in commodities is the biggest thing of to-day and forbodes trouble in the future." A "slump" in commodities means that their price is low because people are not buying them. It does not mean that there are not plenty to be bought; on the contrary. The same writer and many others had for some time been calling attention to the "over-production" of most of the raw materials that go to make our comforts and conveniences, as well as of fuel and the less essential foods. Stocks of tin at the beginning of 1930 were higher than they had been for ten years; before the end of the year they had further increased by 50 per cent. Copper, oil, rubber, wool, coffee, and tea were among the commodities said to be produced in too

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large quantities. The chairman of Barclays Bank summarised a number of calculations in the statement that "whereas the population of the world increased by about 10 per cent. between the years 1913 and 1928 inclusive, the production of foodstuffs rose during that period by approximately 16 per cent., and that of raw materials by 40 per cent."

This abundance is considered an ill, and the remedy most perseveringly tried is to reduce production. A book was published a year or so ago on a method to improve the yield of rubber trees. The plan was denounced by some critics on the ground that if it secured half the results its authors predicted the rubber trade would be ruined. A high yield in rubber is far from their desire; that is why considerable support was found some nine years ago for an elaborate plan of restriction known as the Stevenson scheme. This scheme remained in force for six years, gave little general satisfaction, and was abandoned in November 1928. The Stevenson experiment with rubber had a kind of official sanction and control. Others, not always avowed, have been tried by private agreement between planters or mine-owners.

There are two main reasons why these plots fail. First, it is easy enough to reduce the output of a plantation or minefield, but not so easy to reduce working costs proportionately. In the manufacturing branches of industry, as everybody knows, the modern aim is to increase output in order to reduce costs per unit. Conversely, a planter who reduces his output increases costs per unit; therefore, though his manœuvre tends to raise the price he gets per ton, he

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may be no better off because his expenses are higher per ton. Action still more drastic than is usually taken might for a time be more effective. If the restriction were regarded as permanent, and a ruthless cutting down of capital, staff, and acreage under cultivation were carried out, a condition of maximum profit might be reached. But this is against all the instincts of enterprising men. A planter in a large way of business wants to become a planter in a larger way of business. The prospect of becoming permanently a small man does not please him. Again, at the back of his mind is generally the idea that a restrictive policy, so far as he is concerned, is a temporary measure to cure a temporary ill, and that when prices rise in consequence of the cure, up will go his output once more, to be somehow sold before prices fall again.

Secondly, restriction is also handicapped because it is never complete. The world is still large, and somewhere there have been cultivators not parties to the restrictive agreements. Perhaps they live remote from the main productive fields; perhaps they are of a different race; perhaps they oppose restriction on principle; perhaps their estate was undeveloped and its resources underestimated. The soil is fruitful and the earth is rich; invariably supplies have come to market in good time and in sufficient quantities to affect in some degree the calculations of the restrictors.

It would not be safe to assume, however, that these are at the end of their resources. Control nowadays is moving away from the enterprising and independent

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planter towards the big financial centres, and is exercised by men not moved by the same emotions as the planter of old. Having command of vast credit, they can hold supplies longer than he could, and they are becoming increasingly expert in reaching agreements world-wide in scope. The prospect is sinister, unless we can discover how the earth's fullness, which so much ingenuity is used to nullify, can be a source of wealth to us all instead of an embarrassment.

When we pass from raw materials to manufactures the tale of our vast potential wealth is still more striking. Some years ago a friend of mine owned a small machine for making drawing-pins. These little implements poured from it like rain. In a few hours or days sufficient drawing-pins were emitted to supply all London's requirements for several months. Unfortunately for its owner, his was not the only machine in the country turning out drawing-pins, and in consequence most of its days were spent in idleness.

This machine is typical of modern industrial plant, both in its prolificacy and in the constraint imposed upon its action. No serious social loss is entailed by a failure to deliver millions of potential drawing-pins; the demand for drawing-pins is not urgent or elastic; but the throttling down of the national plant is by no means confined to those units that produce mere inessential conveniences. Goods which many people urgently need, and goods for which many others might be the better, cease to be produced in the abundance that is easily possible because there is said to be an insufficient demand. The condition is generally called over-production. It is a sign of

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enlightenment that we are beginning to recognise it as under-consumption.

Viewed at long range, the trend of production has always been upward. Till the middle of the eighteenth century the curve was gentle; then it steepened. But if the curve of production during the nineteenth century was steep, the curve of productivity was steeper still, and this disparity between potential and actual production is perhaps the most remarkable economic feature of the last hundred years. We produce far more than we did, but we could produce far more than we do. Scarcely a factory in the country to-day would have the slightest difficulty in adding 50 per cent. to its output. Some could double or treble their output if the need arose. The need did arise seventeen years ago, and a grand crescendo began in all our mills and workshops that never ceased to swell in volume during four amazing years.

Now with all this evidence of vast and varied wealth we yet had to tell our Utopian visitor that many people are poor; and we said that they were poor in money. This seemed to be one obvious way of accounting for the simultaneous existence of a plenitude of goods in warehouses and a manifest lack of them in homes. To this an economist might object that poverty in money is simply a way of expressing poverty in goods, not a way of accounting for it. Claims to goods are conferred by money; the poor have few such claims and the rich many; we have merely shown that wealth, whether calculated in goods or in money, is unequally distributed, which everybody knew already; the presence of large stocks of unsold goods only indicates

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that the rich do not spend all their income. If they did, no machines would be idle, no men unemployed, no goods remain unsold in warehouses.

The same type of objector sometimes adds that industry would be healthier and the population more prosperous if the rich now and then indulged in an orgy of spending, buying more clothes, more cars, more books, more of everything the purchase of which depleted stocks and set our factories buzzing to replenish them. Instead, being able to wear only one suit and read only one book and ride in only one car at a time, they are content with very few more of these things than the average man, and the rest of their money they invest. In short, we should be told, the problem of unsold goods arises from the maldistribution of money; and if an absolute insufficiency of money is what we postulate, nothing we have yet said can be offered as proof.

We are not prepared to say now that this is precisely what we do postulate, because the statement would only be true with reservations that can better be made clear later on; neither is this preliminary survey the proper place for a discussion of investment, though its bearing upon the problem we do not deny. By pointing a finger of wonder at those vast stores of wealth and at this dire poverty we do not claim to have proved anything precise enough to be stated in terms of arithmetic. The statistics on the subject have themselves no precision, though there are some available. The national income has been estimated, both in money and in annual output of goods and services, and the figures have sometimes bewildered socialists,

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especially the figures published before the war, for they show that an equal division of incomes would not enlarge that of the average worker by nearly so much as he might have imagined.

The mean figure in the estimates of money income produced by Professor Bowley and Sir Josiah Stamp for 1924 was 3,800 million pounds. The chosen year is the last for which there are also figures of the Census of Production, upon which are based Mr. Flux's estimates of income in goods. The estimated total money income shows that if everybody's income were pooled, and the total equally distributed, the average family would receive about £7 a week. Many families would thus be rendered immensely poorer, but a very large majority would be somewhat better off than they are to-day even when the earners of the family are in full employment.

The effects of such a redistribution are not easily calculable; £7 a week is a meaningless term considered apart from what it will buy, and no one can tell what it would buy were it regularly received and steadily spent, and if, above all, our mills and factories were kept constantly at work. Many commodities of low value would tend to rise in price until industry had accommodated itself to the change, because people whose incomes had suddenly increased, however slightly, would buy small comforts and luxuries that previously they could not afford, especially if the change were regarded as permanent. To balance this, dearer commodities would fall in price, and goods like yachts and Rolls-Royce cars would be quite unsaleable because nobody could afford them.

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A lot might be said for such a change if we could think of no better one, but what matters at the moment is that £7 a week per family does not look in the least likely to absorb all that immense productiveness that is such a striking feature of modern civilisation—unless a heavy fall in prices took place. But to assume a fall in prices is to beg the question, for the argument is that the national money income will buy the goods at existing prices. Still, we cannot claim yet to have refuted that argument.

Neither can we refute it by comparing money income with the value of national output in goods and services for the same year as estimated by Mr. Flux.¹ One object of this estimate was to check the other; there was no idea of discovering whether purchasing power was adequate to buy total production, and had the two results shown a greater discrepancy than might reasonably be expected from the difference in method their compilers would have assumed one or both to be wrong. The results were in fact in fairly close agreement. If we could take them at their face value they would indeed lend some support to the theory of insufficient money, for Mr. Flux's estimate in goods is slightly above the estimate in money. The mean figure between his extremes is 3,975 million pounds.

Little, however, can be inferred from this by either party. For the figures are only estimates, with a fairly wide margin for error, and if the higher limit of the one and the lower limit of the other happened to be correct the position would be reversed. Further, the value of

¹ *Journal of the Royal Statistical Society*, vol. xcii, part i, 1929.

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the goods and services aggregated to give the one result means, at least in many cases, their market price. But price is itself influenced by the amount of money in circulation. Because goods have to be sold somehow, we should hardly expect their total market price to remain for long much above the community's spending power. And this brings us to another argument, according to which the proposition that total money will purchase total goods is not only true but virtually self-evident. The argument is based on the famous Quantity Theory of Money, and as the principle that this theory expresses is fundamental to monetary phenomena an outline of it must now be attempted.

CHAPTER III

THE QUANTITY THEORY

THE Quantity Theory of Money may be summarised thus: Since goods are produced to sell for money, and the purpose of money is to buy goods, the price of goods will depend upon the quantity of money available to buy them. If there are one hundred equal units of goods to be sold, and one hundred purchasers each armed with £1, the price of each unit of goods will be £1. We can imagine a hundred people going to market week by week with their hundred pounds and buying the hundred units of goods for £1 each.

Suppose that one week they each became possessed of an extra shilling. The price of the hundred units of goods (which are still assumed to be all the goods there are) would rise to £1 1s. each. The same thing is true, of course, if we leave our hundred buyers with £1 each and imagine that five more buyers, each with £1, have appeared; in this case each buyer will spend £1 as before, but will get a fraction less than a unit of goods in return. The same number of goods-units have to be divided up among a larger number of money-units. The dealers receive £105 for their hundred units of goods. Prices have gone up because money has

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increased. If, on the other hand, the hundred buyers came along with only 18s. each, the price of each unit of goods would have to be reduced to that figure.

Next, suppose that the buyers and their money remain unchanged, but that 110 units of goods come to market. Then each buyer will get a unit and a tenth for his £1. In other words, the price per unit will be less than £1, because the quantity of money in relation to the quantity of goods has decreased. Lastly, if only ninety units of goods are produced, without a change in the amount of money, the price will go up.

The Quantity Theory of Money is sometimes regarded as the mere expression of an abstract relationship, and an almost self-evident one at that ; in its practical applications, however, it must be regarded as an aspect of the Law of Supply and Demand, and, like all economic laws, it expresses a tendency and an approximation rather than an exact and immutable principle. In practice it does not work quite so neatly as in our example, but it works all the same. A fruiterer brings a good store of peaches to market and offers them, as he has been accustomed to do, at 3*d.* each. Soon he finds that several other fruiterers are also unusually well supplied with peaches. But customers have not acquired any more money just because there are plenty of peaches about, and the fruiterer, after selling a few at 3*d.*, has to reduce his price to 2*d.*, and then to 1*d.* Even so, perhaps he does not make the reductions quickly enough, and has some peaches left that go bad before he can sell them at all.

On another day he hasn't so many peaches, and finds that his rivals have fewer still. He raises the

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price to *4d.*, sells out quickly, and realises with regret that he could have got *5d.* Many willing peach-buyers have gone away empty handed with money in their pockets.

Again, a small tradesman, knowing his customers personally, does not take advantage of every small and temporary shortage to charge more ; neither does an increase of supplies always result in an immediate reduction of price. A customary price tends to stay fixed, in spite of small fluctuations in the ratio of money to goods. But, broadly speaking, the theory, regarded as a statement of a tendency, is correct ; the prices of goods as a whole tend to move up or down till they reach a point at which all the money available is absorbed and all the goods distributed. This does not imply, of course, that the prices of all commodities move uniformly up or down in accordance with the quantity of money. The general level of prices will do this, but those of particular commodities may move less or more than the average trend, or even contrary to the trend, according to the supply of the commodity and the relative demand for it. Our example of the peaches illustrates the Quantity Theory only on the assumption that peaches represent goods and services in general. The price of peaches themselves may move up or down through changes in taste or fashion or supply, irrespective of any changes in the total quantity of money or goods.

Next, one must observe that, to affect prices, it is not enough that money should merely be in existence. The money must circulate ; it must be exchanged for goods ; and this introduces us to a principle the

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importance of which was not fully realised until comparatively recent years. Changes in the speed at which money circulates have the same effect upon prices as changes in its quantity; a given quantity of money may be accompanied by rising prices if the number of transactions it effects in a given time is increased, and by lower prices if the number of transactions is decreased.

Suppose that in a community of a hundred men each man earns £3 per week, paid on Saturdays; then £300 are necessary to pay their wages. Each man spends his earnings at the rate of 10s. every weekday, so that the £300 is back in the bank by Saturday ready to be issued again. Assume now that it is resolved to pay the men daily instead of weekly. Each man receives 10s. every morning, which means an outlay of £50. He spends his earnings during the day, as before, and the £50 has returned by the next morning ready for the new day's wage payments. Thus £50 only need now be in existence. The workmen receive and spend just as much as they formerly did, and the shopkeepers' takings have not altered; £50 does the same work as £300 used to do simply by circulating six times as rapidly. If the change were made in the opposite direction, wages being paid fortnightly instead of weekly, then £600 would be required, though no one would be any better off and prices would not change.

These changes are called changes in the Velocity of Money, or, more fully, the Velocity of the Circulation of Money. The law is that Price equals the Quantity of Money multiplied by its Velocity. If one hundred

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units of goods flow to the market in a given period of time and £100 are available to buy them, the price of each unit of goods will be £1. But if, while the flow of goods is unchanged, the sum of £100 becomes twice available to buy goods with in the same period, the price of each unit of goods will be £2. In other words, the £100 in its first circuit will be exchanged for only fifty of the goods units, the other fifty remaining for the next circuit. If, of course, the quantity of goods be doubled simultaneously with the doubled velocity of money, there will be no change in prices.

Here is a rather unorthodox example of how the Velocity of Money might increase. Manual workers and many others are usually paid their wages and salaries weekly, on Friday evenings or Saturday mornings. Much of this money is spent by Saturday evening, and most of it is in the banks by Tuesday. Suppose the banks, by agreement among themselves, were to say to all employers on Friday: "Encourage your people to spend *all* their earnings during the week-end. Tell them they shall have another week's salary on Tuesday afternoon, as a gift. Do not be alarmed; this is on us; you won't be charged anything. We are at the same time advising shopkeepers to get themselves well stocked."

So the employers do as they are bidden, and the shopkeepers do so, and the workers; and there is great rejoicing that week-end in many homes and behind many counters; followed perhaps by a little anxiety towards Tuesday lest the remainder of the fairy-tale should not come true. But it does, for the bankers have the money back, and it will do them no

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harm to issue it again on the same understanding instead of keeping it idle till Saturday.

What is wrong with this picture ?

It ignores the effect upon prices. Such an acceleration in the movement of money would raise them. Theoretically it would double them—assuming that the incomes of all consumers are affected in the way described. In practice the rise would begin from the old level and mount steeply week by week so long as the new rate of circulation were maintained, and the level reached would depend upon the rapidity with which industry could respond to the new demand for goods.

The practical bearing of this principle of velocity is found in the fact that changes occur in the rate at which people spend their money. They may tend to keep more in their pockets or safes or bank accounts, or they may develop an increased desire for goods and spend their incomes as fast as they receive them. Such changes have an effect upon prices and industrial activity.

We shall find that two of the most important factors in our problem are those which we have just explained : the volume and the velocity of money ; the amount of it that people have, and the rate at which they spend it. The recognition of this explains why the treatment of the quantity theory in modern works has become so elaborate ; once merely a simple guide through the bewildering paths of monetary theory, it has been transformed into an almost complete theory of money in itself. In simpler forms the principle was accepted long ago by economic thinkers. It was evoked by

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John Stuart Mill nearly a hundred years ago in reply to currency reformers seeking an easy way out of circumstances very similar to those that surround us to-day, and reiterated more recently by Mr. Reginald McKenna. A hundred tons of goods, they would say, can be just as easily exchanged for £50 as for £100; the only difference would be in the price. There is no point in giving a man £10 a week instead of £5 if he can only buy the same quantity of goods as before.

Where, then, lies the problem? Why is there any difficulty in getting rid of all the goods there are, no matter how great the quantity or how rapidly we go on increasing it? For it is clear that, according to this theory, the mere abstraction from total spendable money of sums to be saved, or the mere failure to issue more money as the production of goods increased, should create no difficulty; goods should drop in price till the money left is sufficient to buy them. How does the problem arise?

The answer is that, given economic arrangements easy enough to imagine but nowhere adopted, there would be no problem. The sole purpose of producing goods would be to distribute them, and, be the money little or much, distributed they would be. Even as things are, so potent is the law just described that this in the long run is what happens. For what do we see at times when shortage of money is prolonged and acute? Merchants and manufacturers hold on to their unsold stocks till they must get money somehow or go out of business; they then sell at any price that induces people to buy. Cheap goods invariably come on the market during a slump. But these forced sales clearly

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do not occur as part of a considered and orderly distributive scheme whereby everybody is satisfied. On the contrary, they are evidence of embarrassment; producers have got into difficulties from which these sales do not always extricate them. What are these difficulties?

To answer this we must remember that a manufacturer, in fixing the price of his product, is not governed solely by the need to distribute it. Naturally distribution is his intention, which he hopes to carry out even if other manufacturers fail to find customers in consequence of his own success; but his primary concern is to recover what the product costs him to produce. His selling price must be at least that. This, of course, is true of every manufacturer. Therefore the total price of all the goods of every kind produced must be at least equal to the total costs of producing them. It follows from this that total money in the hands of buyers must also be at least equal to these costs of production. Is it?

According to one school of monetary reformers, it is not. The argument on which this contention is based has tantalised quite a number of intelligent people during the last twelve years; and by examining it we shall be helped onward in our inquiry. But we must first prepare ourselves by looking a little more closely than we have done yet into the nature and source of money.

CHAPTER IV

THE CIRCULATION AND SOURCE OF MONEY

To those unfamiliar with economic ideas the circulation of money presents an appearance of baffling intricacy. One pays a shilling to a grocer, who gives it as change to another customer, who buys a railway ticket with it. From the booking-office it goes with many other coins to a bank, and helps to swell a deposit against which a large cheque is drawn payable to a steel manufacturer two hundred miles away. The shilling, meanwhile, emerges again as part of a sum withdrawn by a builder, and helps to pay a carpenter's wages. Similar changes of scene and purpose fall to the lot of many other coins at the same time: can we discern any ordered pattern in the movements?

If we watch a market where much business is done perhaps we may discover a few features common to all the money that changes hands there. We choose a country town one Saturday—a town large enough to supply if need be all the requirements of a civilised community. The shops are well stocked, and there are loaded stalls and barrows in the streets and in the market square. People are coming in from villages near by, and these, like the townspeople, will do the

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greater part of their week's shopping on this day. Where have they obtained the money?

Many of them have obtained it as wages from the farmers; still more as wages or salaries from the workshops and factories in the town. These two classes comprise the majority of the shoppers. Then there are the farmers themselves. There are also the directors of the factories and some shareholders. Obviously their incomes, whether earned or not, are derived from the same source as the wages of the factory employees; they are charges which the factories have to bear and to recover in the form of prices. All these people, then, are spending money directly paid out by some industry or other, whether agricultural or manufacturing, in the course of producing goods; and if there are lorry-drivers and railwaymen as well, these also derive their incomes from industry, for taking goods where they are wanted is as essential to industry as producing them.

But we also find a rather different class of people spending money: solicitors, doctors, musicians, and other professional men. It is easy to see, however, that the incomes of these, too, can be traced back to industrial sources, though they come indirectly. For such men receive fees for services to wage earners, salary earners, dividend receivers, and so on, just as landlords receive rents paid directly by the industrial workers or by those who serve them. There will also be a few municipal clerks, paid out of rates levied on the householders, who earn them in one of the ways already described; a surveyor of taxes paid out of the national revenue, derived from taxes paid either directly out of people's incomes or indirectly as they

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spend their incomes on taxed goods ; there will be some teachers paid in a similar way or privately out of other individual earnings, and there may even be an artist who sells paintings to the rest.

All these incomes, reaching their recipients by various channels, at different intervals of time, and in return for very dissimilar services, have one thing in common : they would all cease if the farms and the factories stopped producing. From whatever source the farms and factories derive the money with which they pay wages, salaries, and dividends, from that same source is derived also the fees and rents and honorariums of the rest of the community. The sums available to shoppers on this Saturday afternoon all passed through the producing and distributing organisations as costs—and they are about to return through the same channel as prices.

For by nightfall the shopkeepers' tills will be full. By Monday the money will be banked, ready to be remitted to the wholesalers (in the form of cheques drawn against deposits) who in turn will pay manufacturers and farmers. Naturally the shopkeepers themselves will have done a little shopping for their personal needs. This may be regarded simply as an exchange of goods among themselves. The total amount of money in their combined tills is not affected. Neither does any essential difference lie in the fact that many of their customers will pay for their purchases at long or short intervals by cheque. The money will go the same way as the rest, and thus we have a vision of a whole community's spending power flowing out from industrial organisations in the course of

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producing goods, and flowing back thereto as goods are sold. That is how money circulates. Of what does it consist?

In a sense any commodity that a man did not want and exchanged for something he did want could be called money, but this definition is too inclusive to be of service. If, however, the man to whom he transferred his unwanted commodity also did not require it for use but to exchange with a third man for something else, and only accepted it because he knew he could so exchange it, then the commodity has begun to assume the character of money in a stricter sense; it is used as a medium of exchange. Primitive moneys were commodities which the possessor could use himself or exchange for other commodities. Fish-hooks, spear-heads, dried fish, tobacco, cowrie shells, and many other goods desirable for consumption or ornament have been used as money by various races. These things passed from hand to hand, and often in doing so lost much of their intrinsic virtue without losing their monetary character.

Clearly, the use of money of any kind facilitates exchange. If you have a surplus of apples and desire timber, without a system of money you must not only find a man who desires apples; he must also have a surplus of timber. The use of money enables you to sell your apples to anybody who wants them, whether he has timber or not, and to exchange the money for timber with any timber merchant, whether he wants apples or not. But money also serves another purpose.

Whatever form it took people would not have used it long before knowing exactly how much of it would

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normally exchange for given quantities of any other commodity; the exchange value of all commodities would begin to be expressed in terms of the one employed as money. Thus money provides a standard of value; and it might be used to measure the value of things whose owner, though wishing to sell them, had no desire for the commodity in which their value was expressed. For example, oxen have been used as money; but when we read that a bronze shield equalled nine oxen and a tripod four oxen, we may imagine that a man making bronze shields would not invariably demand nine oxen in exchange for a shield; he would accept something else that was worth nine oxen. Thus the oxen would serve as a measure of value but not as a medium of exchange; and it might continue to do this long after oxen had ceased to be used as money in any other sense, and even if they had ceased to exist. In the same way we could continue to measure values in sterling pounds though no pound notes or gold sovereigns or other embodiments of the unit any longer existed. Money based on such purely conventional units is called "money of account."

So long as money were made of a commodity scarce in quantity, or hard to fashion into acceptable shape, its amount would not increase rapidly. It might even decrease, if it were not durable, or if people tended to consume it. Assuming a community with a stable output of goods and a quantity of money that did not vary in amount, the prices of all other commodities stated in terms of this one would tend to remain constant. But if some one came upon a vast store of the monetary material in spendable form, or discovered

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an extremely easy and rapid way of making it, he might levy a high tribute upon his fellows before they discovered what had happened and brought the issue of money under public control.

Long ago the precious metals, silver and gold, displaced all less durable commodities as money, and of these gold is now established as the monetary basis in practically all civilised countries except China. The durability of these metals enables money to perform a third function: money becomes a store of value, as well as a measure of it and a medium of exchange. A man who accumulates dried fish or sticks of tobacco would find his wealth diminishing through nature's chemical action. Gold and silver are almost impervious to such influences, and retain their value so long as they retain their general acceptability.

But if money were all made of gold, or any scarce material, its quantity could not increase fast enough for a growing and prosperous trading community. A shortage of money would make itself felt. Prices would be low, for goods would be abundant compared with money. To overcome the difficulty of making gold coins minute enough for small purchases, coins of some less precious substance would circulate. These would bear a nominal relationship to the standard gold unit, and would be generally accepted in small amounts. But the shortage of money for larger transactions would remain.

Moreover a high value even in gold is a cumbersome parcel, and people would avoid moving it in bulk if they could. To guard against theft, men with more gold than they required for immediate use might store

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the surplus with a bullion-dealer or a goldsmith. He would issue a receipt ; and a man with a goldsmith's receipt for £100 worth of gold who owed just that sum to his neighbour might pass the receipt to the neighbour instead of drawing out the gold and delivering that. The creditor himself, thus paid off, might transfer the receipt to a third person in settlement of a debt of his own, and the receipt might thus circulate a long time before returning to the goldsmith as a demand for gold.

Finding the practice growing among his customers, the goldsmith could facilitate it by issuing his receipts in smaller denominations. Thus, instead of giving you one receipt for £100 of gold he might give you ten receipts for £10 each, and you would not have to find one person to whom you owed £100 before being able to use the receipts as currency. You could discharge a debt of £10 with one of them, so long as your creditor had confidence in the goldsmith who issued it. Thus a means of economising gold by supplementing it with paper notes might be said to have been discovered almost by accident.

In time the safeguarding of gold for other people may become the principal part of this goldsmith's business. He is their banker, and his receipts or notes are accepted over a wide area instead of gold, which is demanded with diminishing frequency ; and because so much of the gold deposited with him remains permanently in his possession, the banker could safely lend some of it at interest. Alternatively he might retain the gold and issue notes to borrowers who had made no gold deposits. By either method the result is the same : more notes are issued than there is gold

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in the bank. The Bank of Amsterdam, which with other continental banks flourished in the seventeenth century, secretly lent a large proportion of the gold for which it was liable, but because the loans took forms which precluded their rapid recall the bank was unable to meet its obligations when a crisis arose, and its credit collapsed. Largely in consequence of this, added to the growth of British commerce, London became the monetary centre of the world.

In England thereafter many banks began to issue their own notes, but failures to redeem them in gold were frequent, and from time to time public confidence in bank notes waned. Restrictions upon the issue of notes began to be imposed by law till, finally, the privilege was confined to the Bank of England. We have long lost our distrust of paper, and to-day currency notes circulate freely without any question of their validity arising, in this country at any rate, and with scarcely a thought of a relationship to gold ever passing through the minds of those who use them. Apart from bankers and economists, in fact, few people could say with any certainty exactly when, since 1914, currency notes or bank notes were convertible into gold, or under what conditions. So long as they are convertible into goods no one minds.

In the Bank of England, at the moment of writing, there are about 160 millions of pounds worth of gold. This is practically all the monetary gold in the country, and not a sovereign of it is in circulation. The currency and bank notes issued amount to nearly 420 millions of pounds, of which rather more than 50 millions are in the Bank of England, and about 360 millions in circulation—that is, in people's pockets, in tradesmen's

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tills, and in the safes of banks throughout the country. These notes, plus a little silver and copper, are all the cash that we handle nowadays. Currency notes are to a bank what gold was before the war. They are legal tender. The currency notes, however, though a good deal larger in amount than the gold they have displaced, would still be quite inadequate to our requirements if no other means of exchange existed. But such a means does exist—the cheque.

When you open an account with a bank by paying in money the banker does not give you negotiable receipts or bank notes; he gives you a cheque-book. A cheque is an order to a banker to pay whatever sum of money you specify out of the amount you have deposited with him. If it were the custom of everybody to whom you remit money by cheque to rush round to the bank and demand cash, the banker could do little with the money his customers have deposited except look after it. He knows, however, that quite a number of the cheques you draw will be sent to other customers of his who use cheques themselves. They will simply pay in the cheques to him and leave the money there for a time, to draw cheques later on in favour of still other customers.

All he has to do, then, is to make entries in his books reducing your account by the amount of the cheque and increasing the amount shown in the payee's account. Thus the quantity of cash deposited with him is greater than the amount he is ever called upon to pay out, and the more general the use of cheques becomes the smaller the proportion of cash he needs to hold. He can lend some of it to other people. Even if your cheque is sent to a customer of another bank,

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it will probably be paid in and left, and as at the same time some customer of the second bank may be sending money to you or another of your banker's customers, only the difference between the two amounts need be settled by a cash payment. The banks have an elaborate system, operated through a Clearing House in London, of balancing their accounts with each other from day to day, and the differences are reflected in the account which each bank keeps with the Bank of England. The transferred balances are very small compared with the volume of monetary business transacted.

Let us for the present confine our attention to a single bank, much too small a bank to be practicable in real life, but not too small for accurate illustration. This bank is a microcosm of the whole banking system, and I will suppose myself to open it one morning in an extremely small community. As soon as I do so ten of the more prominent citizens become customers by depositing £10 each in cash on current account. (We may ignore my own liquid capital; the capital of all the deposit banks is trifling compared with the sums they handle.)

I now have charge of £100. This represents the spending power of the community, apart from a little loose cash kept by my customers and others. The unbanked cash will not be much; people with banking accounts do not keep large sums in their own possession, and others have not got them. Moreover, the amount cannot vary—apart from being paid into or drawn out of the bank—for private people are not allowed to print notes or mint coins.

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My ten customers have dealings with each other, and settle their bills by cheque. The cheques are usually paid in without withdrawals of cash. Sometimes Mr. Ambrose's account is reduced to £8 and Mr. Hacker's increased to £12. It makes no difference to me; I still hold £100. Occasionally cash is withdrawn, but I find that the cash I hold seldom falls as low as £80 and often I have the entire £100.

To me one day comes Mr. Jolly, whom I know to be an honest and worthy citizen.

"Look here," he says. "You know my little workshop. I make all sorts of things, and I find that there is rather a demand for this new wireless stuff. Just now I'm rather busy, but Mr. Blake has a son ready to go out to work. If I had a little money I could buy some material and take on young Blake at a small wage, and install a few sets for people about here."

"How much do you want?" I ask. "Ten pounds?"

"Perhaps I shall need twenty," says Jolly. "It may be a few weeks before I get any return."

I concur, and open an account for Mr. Jolly. He has paid no money, but I allow him to act in precisely the same way as if he had paid in £20. He buys materials for his new undertaking, and pays for them by drawing cheques. These cheques go to other customers of mine, who simply pay them in, their balances being correspondingly increased. Young Blake's weekly wages regularly call for cash, but even this comes back to me soon, when Blake or his mother spends the money at the local store, whose proprietor is Mr. Hacker, another customer.

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But I have now done an enormous thing ; I have increased the spending power of that community by £20. Had Mr. Jolly not thought of coming to me he would either have dropped his plan or borrowed the money from other people—say £10 each from Ambrose and Hacker. These two people for the time being must have curtailed their own expenditure ; their £20 would have been transferred to Jolly, and no additional purchasing power would have been created. As it is, Ambrose and Hacker go on buying goods, transferring their money to each other and to the rest of my customers, quite ignorant of the fact that I have lent it to Jolly. In truth I have not really lent their money at all ; I have created new money. I may call it credit, but it is in effect money, and has the same consequences as printing so many bank notes, or minting so many coins. I have *pretended* that Jolly has deposited £20 with me, and so long as everybody with whom he deals pretends that his cheques are money and acts accordingly, they *are* money in every sense that matters. The amount of money circulating in that little community has increased as though by magic.

This increase is reflected in my books. Had I drawn up a balance sheet after opening accounts for my ten original customers, and before Mr. Jolly has his loan, this is how it would have appeared :

<i>Liabilities</i>	<i>Assets</i>
£ s. d.	£ s. d.
Deposits of Customers 100 0 0	Cash 100 0 0
£100 0 0	£100 0 0

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Mr. Jolly now buys his material and makes his sets, but has not yet sold them. Assuming that all his payments were made by cheque, or that any cash withdrawn has filtered back to me through the shops, my balance sheet now assumes this form :

<i>Liabilities</i>			<i>Assets</i>				
	£	s.	d.		£	s.	d.
Deposits of Customers . . .	120	0	0	Cash . . .	100	0	0
				Advances to Customers . . .	20	0	0
	<hr/>				<hr/>		
	£120	0	0		£120	0	0
	<hr/>				<hr/>		

The deposits of my customers have increased by £20, though no new customers have arrived with this amount of cash. The new money is my creation ; that " every loan creates a deposit " is a well-known banking axiom. This money appears among my liabilities, for a deposit is a bank's liability, even though it is derived from a bank loan. If, for example, I allow Jolly to draw a cheque in favour of Ambrose, Ambrose's balance is swollen by £20, and he may withdraw this if he likes ; I am liable to Ambrose for that sum. But Jolly is liable to me for the same sum, and his liability is my asset. The £20, therefore, also appears upon the opposite side of my balance sheet in an item called " Advances to Customers."

Let us now show what has happened in rather more detail by separating some of the accounts. Jolly buys all his material from Ambrose, a dealer in metal and sundries, for £12. Blake's wages, amounting to £8, are spent at Hacker's store and banked. Ignoring

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all changes not relating to Jolly's expenditure, here is the position :

<i>Liabilities</i>			<i>Assets</i>		
	£	s. d.		£	s. d.
Deposits :			Cash	100	0 0
Ambrose	22	0 0	Advances to Cus-		
Hacker	18	0 0	tomers	20	0 0
Others	80	0 0			
(8 of £10 each)					
	<hr style="width: 100%;"/>			<hr style="width: 100%;"/>	
	<u>£120</u>	<u>0 0</u>		<u>£120</u>	<u>0 0</u>

(If £4 of young Blake's wages had remained in his mother's purse instead of being spent with Hacker and banked, certain changes would have resulted in the preceding balance sheet. My cash would be only £96 and Hacker's deposits only £14. Thus the total of my liabilities and assets would be £116 instead of £120.)

Jolly now sells his sets for £24 to several of my unnamed depositors, and the result is shown thus :

<i>Liabilities</i>			<i>Assets</i>		
	£	s. d.		£	s. d.
Deposits :			Cash	100	0 0
Ambrose	22	0 0	Advances to Cus-		
Hacker	18	0 0	tomers	20	0 0
Jolly	24	0 0			
Others	56	0 0			
	<hr style="width: 100%;"/>			<hr style="width: 100%;"/>	
	<u>£120</u>	<u>0 0</u>		<u>£120</u>	<u>0 0</u>

Jolly now has £24 to his credit, but of this he owes me £20. I can exact repayment, just as I made the loan, simply by adjustments in my books ; I reduce Jolly's balance to £4 and cancel the Advances to

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Customers. Thus the total of deposits among my liabilities returns to its original size, though the allocation of the deposits among my customers is different. Some customers have less, but in compensation they own wireless sets; others have more through having sold the wherewithal to make the sets.

Bank book-keeping is naturally a more complicated business than it has appeared to be here; but in essentials this is a true description of the most important items in a bank balance sheet. The essentials are that the sum shown as "deposits" includes bank loans; that these are money and can buy goods and affect prices; that how much of these deposits are loans—that is, bank-created money—can be approximately ascertained by comparing the total deposits of all the banks with the amount of cash; that bank loans are created or destroyed at the will of the bankers. The will to create or destroy them is affected by circumstances that will be mentioned later. Meantime it is apparent that if I now destroy Jolly's credit and refuse to reissue it he must sack Blake's son and discontinue his purchases of metal from Ambrose.

But I see no reason to destroy it yet. The scheme has proved a perfectly workable one. Soon I find I can lend out larger sums without evoking a greater demand for cash than I can meet. With no additions to the customers who open accounts by depositing cash, I lend as much as £300. Instead of increasing the purchasing power of the community by a mere 20 per cent., I have increased it by 300 per cent. I have lent more money than I have got! And the more people I can persuade to bank with me and use cheques

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instead of cash, the more I can lend in proportion to the cash I hold.

It is true that a small man like Mr. Jolly, with no bank account to start with, might not easily find a banker so ready to trust him as I was. But even a new concern, if it is sound, will experience no great difficulty in obtaining credit to fulfil orders, save perhaps during a period of credit contraction. I could, of course, have started my credits by loans to existing customers. The introduction of Mr. Jolly makes the illustration clearer, but the effect is no different. What I have shown myself to do as a banker in a small way is what bankers in a large way do ; and so far it looks like a very good scheme for everybody.

In time the credit I have issued becomes by far the greater part of the spending power present in that community. The cash is insignificant, as it is in the larger commerce of reality ; it is credit that has enlarged factories, installed new machines, opened new shops and filled their shelves with goods. This is no less true though the operation be sometimes hidden. The small shopkeeper may not owe me a penny ; he owes the wholesaler, who keeps him supplied and waits for his money till the goods are sold ; but it is my loans to the wholesaler that enable him to do so. All this spending power I control—and if I withdraw it the results are as stupendous as its issue has been.

CHAPTER IV

BANK CREDIT

LOANS from banks take two principal forms. A manufacturer may obtain an advance to execute an order, or a merchant to replenish his stock of goods. They have at the moment no money in the bank, but they are allowed to draw cheques as if they had. Either they may overdraw up to a certain limit, or a definite sum is placed to their credit at once. The greater part of bank credit issued to industry to-day takes the form of advances or overdrafts of this kind.

The other form is the bill of exchange. If you send goods to a Glasgow retailer, say, knowing that he cannot pay you for them yet, you may send him a bill of exchange for his "acceptance." This is a document ordering him to pay you (or it may be your banker) a certain sum of money forthwith or at a specified date. He "accepts" it—that is, he writes the word "accepted" across its face and signs it—and it becomes a promise made by him to pay you, or anybody to whom you assign it, the amount for which it is drawn on the date when it matures. A bill may be payable on acceptance, or a month, two months, three months, or even six months later.

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Having received back your bill from Glasgow, duly accepted, you may not find it convenient to wait for your money till the bill matures. You therefore endorse it as you would a cheque and take it to a banker, who gives you the money, or credits your account with it, less a discount by way of interest. (We speak of the interest on a loan and the discount on a bill of exchange, but there is no real difference.) The banker will eventually collect the money from the Glasgow retailer; meantime he has created a similar sum, less the discount, for your immediate use.

Not all bills are thus discounted by a joint stock bank and held till the acceptor pays. Many bills are bought by discount houses and brokers. These keep themselves acquainted with the standing of merchants in all parts of the world, and may discount bills that an ordinary deposit bank would prefer not to handle. But the brokers and discount houses are themselves largely financed by credit borrowed from the banks, which in this indirect way finance many more bills than they purchase. Bills bought in the money market may change hands many times in settlement of debts before they mature.

The bill just described, drawn by one trader and accepted by another, is of a simple and direct type formerly much used for home trade. The Macmillan Report recommends a more general use of the bill of exchange between home traders. At present it is mainly used to facilitate international trade, and, though the document is essentially the same, the usual procedure is a little more complicated.

Suppose that you are exporting machinery to a

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Dutchman named Pieter, who wishes to pay for it three months hence. You may draw a bill on Pieter, and Pieter may be an excellent fellow; but his excellences may be unknown to the London money market, and his acceptance of your bill may not be good enough to enable you to dispose of it readily. Pieter knows this quite well, and he therefore goes to his own banker in Amsterdam, who has complete faith in his integrity. As a result, you are instructed to draw your bill on the Amsterdam bank instead of on Pieter. The bank accepts it, thus becoming responsible for its payment, and the bill becomes much more easy to negotiate.

Still another procedure is quite a likely one. Pieter may arrange for a credit to be opened on his behalf in London. You then draw your bill upon a London bank or one of the famous accepting houses (sometimes called merchant banks) that specialise in such business, and by this institution it is accepted. The formalities whereby the acceptor assures himself that Pieter will honour the bill when payment falls due need not concern us. The important thing is that you now have a bill drawn on London, with a London bank's acceptance, which is the most highly esteemed of all bills and will be readily discounted on the most favourable terms. You therefore get your money at once, though Pieter has not yet paid a penny.

Similarly, if you are an importer you may arrange for a London bank's acceptance of bills drawn by your suppliers. Thus the good name of London credit institutions helps to finance both import and export trade. For accepting a bill the acceptor charges a

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small commission ; but it is not he, as acceptor, who lends any money. The money comes immediately from the broker or discount house that buys it from the drawer, and ultimately for the most part from the joint stock banks. Some bills have a less direct connection with industry than those described. They are drawn by a person who has supplied no goods but wants to raise money, and accepted by someone who knows this is the case but is willing to be accommodating, since it will cost him nothing and he will draw a commission. The bill is sold in the discount market, like any other bill. By permitting "finance bills" of this kind to be drawn upon them, London banks and acceptance houses may enable foreign banks to acquire short-term credit in London, to be used as required. Similarly, London may be granted credit by being allowed to draw bills on foreign banks.

In the two forms now outlined, advances and bills of exchange, vast amounts of spending power are constantly pouring out from the banks, to which they flow back in other forms. Their magnitude can be inferred from the banks' balance sheets, and from the bankers' clearing house returns. The current balance sheet of one big bank alone shows deposits amounting to more than all the legal tender currency circulating in the whole country.

Every week a return is issued showing the value of the cheques cleared by the principal banks. Since it excludes payments made between customers of a single bank the return understates the facts. Figures that include these payments were published in the Macmillan Report. During 1930 the average monthly

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total was over 5,300 million pounds. In other words, payments amounting at least to this sum were made every month, on an average, without the use of legal tender currency.

Here is an abridgement of the balance sheet for December 31, 1930, issued by one of the Big Five Banks. A few small items are omitted, the various issues of capital are lumped together, and the totals are given in round numbers.

<i>Liabilities</i>	<i>Assets</i>																																							
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10px;"></td> <td style="text-align: center;">£</td> <td></td> </tr> <tr> <td>Deposits . . .</td> <td style="text-align: right;">364,648,000</td> <td></td> </tr> <tr> <td>Capital and Re- serves . . .</td> <td style="text-align: right;">25,810,000</td> <td></td> </tr> <tr> <td>Items Omitted . .</td> <td style="text-align: right;">43,802,000</td> <td></td> </tr> <tr> <td></td> <td style="text-align: right; border-top: 1px solid black; border-bottom: 3px double black;">£434,260,000</td> <td></td> </tr> </table>		£		Deposits . . .	364,648,000		Capital and Re- serves . . .	25,810,000		Items Omitted . .	43,802,000			£434,260,000		<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10px;"></td> <td style="text-align: center;">£</td> <td></td> </tr> <tr> <td>Cash . . .</td> <td style="text-align: right;">42,620,000</td> <td></td> </tr> <tr> <td>Money at Call and Short Notice . .</td> <td style="text-align: right;">28,990,000</td> <td></td> </tr> <tr> <td>Bills Discounted</td> <td style="text-align: right;">53,733,000</td> <td></td> </tr> <tr> <td>Investments . .</td> <td style="text-align: right;">50,347,000</td> <td></td> </tr> <tr> <td>Advances . . .</td> <td style="text-align: right;">175,311,000</td> <td></td> </tr> <tr> <td>Items Omitted . .</td> <td style="text-align: right;">83,259,000</td> <td></td> </tr> <tr> <td></td> <td style="text-align: right; border-top: 1px solid black; border-bottom: 3px double black;">£434,260,000</td> <td></td> </tr> </table>		£		Cash . . .	42,620,000		Money at Call and Short Notice . .	28,990,000		Bills Discounted	53,733,000		Investments . .	50,347,000		Advances . . .	175,311,000		Items Omitted . .	83,259,000			£434,260,000	
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Most of the items will now be fairly intelligible to the reader. The Cash among the Assets is the till-money kept by the various branches of this bank throughout the country plus the bank's balance at the Bank of England; it is all the cash it could immediately command in the incredible event of a simultaneous decision by all its depositors to withdraw their balances. The Money at Call and Short Notice is chiefly money lent in the money market—that is, to bill brokers and discount houses—and to stock-brokers, for periods ranging, as a rule, from a few hours to fourteen days. The borrowers in the money market use it to discount bills of exchange.

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The next item comprises the bills which the bank has itself discounted ; it will probably hold them until they mature. The bills held by any bank include a quantity of Treasury Bills, a form of floating debt by which the British Government borrows from the money market.

The Investments are practically all in British Government securities and similar gilt-edged stock of the highest kind.

By far the largest single item among the assets is the Advances to Customers. These are loans made to manufacturers and merchants to enable them to carry on their business, and is the form of credit with which this book is mainly concerned.

Of the 83 millions not here separately allocated some 13 millions represents cheques in course of collection on, and balances with, other banks, and most of the rest consists of self-balancing items arising from the bank's practice of accepting bills and in various other ways acting as guarantor for its customers. Practically the whole of the unallocated sum on the liabilities side is made up of such items. For our purposes they may be ignored ; in so far as they have been converted into money the amounts will be included in the deposits of one bank or another.

The Capital among the liabilities represents, of course, the sums contributed by the shareholders. Most of a bank's liabilities are the deposits of its customers.

The word " deposit " sometimes misleads novices. It has unfortunately two meanings. A deposit account is one on which a bank pays interest, the depositor

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agreeing not to withdraw his money without giving notice, seven days being the period of notice usually required. In this sense a deposit account is distinguished from a current account. But the deposits which make up most of a bank's liabilities include both deposit accounts in the narrower sense and current accounts; indeed, a bank's balance sheet usually makes this clear by mentioning both accounts, though without separating the sums belonging to each. In discussing monetary theory, however, it is usual to speak simply of "bank deposits" in an inclusive way, though the difference between the two forms sometimes becomes important.

These deposits consist, as we have seen, mainly of loan credit. This contention has been resisted on the ground that an examination of the deposits of any bank would show that the greater part of them belong to depositors who are in no sense the bank's debtors. On the strength of these deposits the banker makes loans; therefore, it is argued, he does not create credit; he simply relends what his customers lend him, and consequently does not add to the spending power in circulation.

If the argument were otherwise valid, it would still fail to show that the banker does not create credit. A banker who lends me £50 because you have deposited £100 gives me spending power that I did not possess before. Your own £100 does not cease to be spending power. But the whole argument is due to a misunderstanding.

Suppose there to be, as there are, five big banks of approximately equal size, and suppose that one of

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them advances to its customers 150 million pounds. The borrowers will draw numerous cheques against these advances, and we should expect these cheques, by the law of averages, to reach customers of all five banks in approximately equal proportions; one-fifth only of the payees would be customers of the bank issuing the credit. At the same time the remaining banks would be issuing loans, and one-fifth of their volume would come to swell the deposits of the first. Assuming exact equality in these exchanges, our original banker would hold deposits amounting to 150 millions. Of this sum, 120 millions would have reached him in the form of cheques drawn upon other banks, and concerning any particular cheque he might declare that he knew not whether it originated in a bank loan or otherwise. Concerning the whole amount, however, he knows perfectly well that the bulk of it is bank credit, because he knows that other banks conduct their business on the same lines as he does his.

In the balance sheets issued for December 1930, by the Big Five banks and five smaller banks represented on the Bankers' Clearing House, the Advances alone, excluding other forms of credit, amount to 929 million pounds, and the total deposits exceed 1,925 millions. All this spending power is, in every sense that matters, money. Only banks and the State may issue money: that issued by the State is usually called cash or currency; that issued by the banks is called credit. Our State money, issued under the authority of the Government by the Bank of England, amounted during the greater part of 1930 to approximately 420 million pounds, of which about 360 millions only

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was in circulation. Indeed, by the beginning of 1931, when these bank balance sheets were published, the volume of issued currency notes had shrunk to less than 400 millions by withdrawals of gold, entailing the cancellation of notes, and the notes in circulation amounted to fewer than 350 millions. Yet bank deposits are five and a half times this amount; and when we compare the cash held by any one bank with the deposits for which it is liable the disparity is greater; the cash is approximately 11 per cent. of the deposits, reaching or exceeding this proportion when the balance sheet and other periodical statements are prepared, and falling below it at other times. The difference between the cash and the deposits can only be due to the creation of bank money.

Though familiar enough to economists, these facts have been surprisingly unfamiliar to social reformers of most schools until quite recent years; and even when they have become known their implications are curiously misunderstood. To show that the banks issue so much credit against so little cash is taken as a criticism of the banks' solvency, and defenders hasten to explain that little or no credit is issued unless adequate securities are given by the borrower. If in an emergency cash is required, it is argued, the bank can call in its loans, and if the borrowers cannot pay, then the securities they have deposited can be sold.

Even were this relevant, it is only true to a limited extent. As soon as loans are granted they begin to be spent, and to recall any large proportion of them at short notice would be impossible. To sell securities might be equally difficult, for in such circumstances

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there would be few buyers. Still less would this remedy be available if the emergency supposed were a panic demand for cash—that is, legal tender currency—since any securities bought would be paid for by credit instruments of some sort. Moreover, considerable sums are in fact lent on no security but the integrity of the borrower and the assumed soundness of his business. The chairman of one great bank stated a few years ago that no less than 28 per cent. of its borrowers had their loans wholly unsecured.¹ Still, the bank may be solvent enough, judged by the tests of solvency applied to any other business, and the only reason why the question of solvency is confused, in the case of a bank, with an ability to pay all its liabilities in cash is because a bank deposit does in legal fact constitute a claim for cash on demand. If all such claims were presented at the same time no bank could meet them; but experience shows that such a contingency is not likely to arise, and the banks can hardly be condemned for not conducting their business as though it were.

Ignoring panics, therefore, as a confusion of the issue, we fix our attention upon the enormous responsibility borne permanently by the banks in our economic structure. They issue by far the greater part of our spending power; by choosing who shall have it they can exercise much influence in determining what shall be produced; and within very wide limits they are subject to no public control.

Leaving aside the question of political rights, let us

¹ The late Dr. Walter Leaf, at the Annual Meeting of the Westminster Bank, 1923.

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regard the banks solely as a reservoir of credit. From this reservoir, credit—which is spending power and may as well for our purposes be called money, as it is by modern economists—flows out to industrialists, is used by them to pay for the services they buy, becomes the income of those who render the services, is spent in buying the goods they have produced, reaches in this way the merchants and industrialists as sellers, and is returned to the reservoir.

CHAPTER VI

A RISE AND FALL OF PRICES

WE can now follow the flow of money through the industrial channel, on the watch for that deficiency whose existence certain theorists proclaim and many people with no theories at all will eagerly confirm. The most thoroughgoing of those theorists is Major Douglas, and we shall not be taken out of our course if for some distance we follow his argument.

At any given time, says Major Douglas, the money in the hands of consumers is less than the total price of all unsold goods when this price is arrived at by calculating the cost of producing them.

At first sight this looks obviously false. For what are costs but payments? No matter what form these payments take, whether wages to mechanics, salaries to clerks and managers, fees to directors, or even profits to shareholders—which are not technically regarded as an item in costs as a rule, but must be counted among the total disbursements—they all represent purchasing power. In what proportion these payments are distributed does not affect the question; added together they form the costs of production in the most inclusive sense; they are what the price of

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the product is made up of ; and it seems nonsense to assert that they cannot buy the product at that price. Even when we remember that a factory usually obtains raw material, plant, and sundry components from outside sources, the case does not appear to be different ; for these items have to be paid for (otherwise they would not add to costs) and the payments made are purchasing power in somebody's hands. Yet it was by reflecting on this dual nature of the costs incurred by any one factory that Major Douglas was led to formulate his theory.

While examining factory accounts in an official capacity during the war he noticed that a factory's costs were always in excess of the money it directly distributed to its own workmen, staff, and shareholders. Naturally this was so, for every factory obtains material of one kind or another from other concerns. But "if this is true in one factory," he writes, "it must be true in all. Consequently the total amount of money liberated by manufacturing processes of this nature is clearly less than the total selling price of the product." ¹ In other words, if every factory fails to distribute to its own personnel enough money to buy its own output, all the factories together fail to distribute enough to buy their combined output.

Again the reader will see a catch. Admittedly, he will say, a firm making boots does not pay out enough money to its staff and shareholders to buy those boots ; for the price of the boots must include the cost of leather, machinery, and so on ; but the men who make the leather and machinery do not consume such

¹ *Economic Democracy*, p. 59.

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things; they consume boots. Their incomes, therefore, will supplement those of the boot factory's staff, and the boots can be sold.

Not so, says Major Douglas. For those who made the raw material and machines received their wages weeks or months ago and have since spent them. These payments have returned to the banking reservoir long before the boots reach the market.

The argument depends, then, on the fact that a commodity passes through processes which may be paid for over widely separated intervals of time, though all these payments are concentrated in its price when it reaches consumable form.

Let us first imagine the production of all the goods that individual consumers want, but no others, to be concentrated in one large factory belonging to a single company. This company makes all the boots and all the other commodities, from soap to motor-cars, needed or desired by the private consumers in a complete community; and we will call this company Household Goods, Ltd. For simplicity we will eliminate shops, presuming that Household Goods has a distributing department at which everybody deals.

Now Household Goods, Ltd., is continually buying steel, leather, oil, coal, tools, spare parts for its machines, semi-finished goods, and so on, from a variety of other concerns; but let us group all these into one company called Factory Supplies, Ltd.

These two companies represent the whole productive organisation of the community; through them is issued all goods. Through them also is issued all money, which for the present we may regard as cash.

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For convenience we must assume that Household Goods exactly replenishes its wastage week by week, and that all payments are made as soon as goods change hands.

In fact, we may simplify still more. We will forget the machines and tools and the variety of forms that goods take in their passage from mother earth to the shop counter, and think simply of a composite product called goods which passes through two stages of manufacture, each occupying a week. The first stage is that in which Factory Supplies converts them from mere minerals or plants into semi-manufactured products, and the second is that in which Household Goods converts them from semi-manufactured products into finished commodities ready for the consumer.

Each of these factories—which may be assumed to employ the same number of people—pays out money week by week. These payments take various forms, but we shall lump them together. The fact that while wages are normally paid weekly, dividends are usually paid at longer intervals, does not matter; we shall assume that the weekly disbursements of each factory include all such charges.

Every Saturday morning, then, Households Goods pays a week's wages, salaries, and dividends. The sum of all these payments, is, say, £1,000. (Our imagined community is a miniature one.) By this time there are accumulated in its distributive department all the consumable goods manufactured during the week. At what price can these goods be sold?

If the company is not to get into difficulties they must be sold for not less than they cost. (And they

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need not be sold for any more, since we have included profits among costs.) Their costs, so far as we have counted them at present, are £1,000; but this represents only the cost of converting semi-manufactures into finished goods, whereas the semi-manufactures must be paid for. They were, in fact, paid for a week ago by Household Goods, Ltd., when this firm bought them from Factory Supplies. They cost, let us say, another £1,000. Therefore the total cost of the week's finished goods ready for sale every Saturday morning is £2,000, and that is their price. Where is the £2,000 coming from?

The answer does not seem hard to find. True, we see that the amount cannot come from the staff and shareholders of Household Goods, for these have only £1,000 between them; they cannot buy their own product. But neither should they expect to, for they contribute only half the effort required to produce it; the other half is contributed by the staff of Factory Supplies, Ltd., and it is plain that these individuals are entitled to half the finished product. Moreover, they are able to buy it, for Factory Supplies too distributes £1,000 each week in wages, salaries, and dividends, and the consumers as a whole therefore have a total of £2,000 every Saturday afternoon. But this total, £2,000, is exactly what the commodities now ready for sale have cost. Can they not therefore be sold and the account balanced?

We are dealing, let us remember, with a specific batch of goods. Household Goods has to recover the cost of the particular stock of goods ready for sale on a certain Saturday afternoon. Let us call this stock

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Batch C. Bearing in mind that all costs are payments, we have to see whether the particular payments made in the course of producing Batch C are available to buy Batch C when produced. If they are, it can be sold, and the Douglas theory falls to pieces.

Batch C is ready for sale by noon of March 12. The work done on it by Household Goods was begun and completed during the week ending March 12, and payment made to the staff on that morning.

But the work done by Factory Supplies towards producing Batch C (the preparation of the raw material, and so forth) was completed before Household Goods had anything to do with it ; was begun and completed, in fact, during the week ending March 5, and on March 5 £1,000 was paid to the staff. Not unless they starved for a week will this money still be in their possession on March 12. We know that instead of starving they will have spent the money ; but what on ?

Clearly not on Batch C, since Batch C was not at that date in existence as a consumable product. The staff of Factory Supplies spent their £1,000 on Batch B, which had come to the market on that very day, March 5. Thus, although £2,000 has been spent on producing Batch C, only half of *this particular* £2,000 is available to buy it on March 12—the half distributed that day by Household Goods to its own staff. Either Household Goods must sell its wares for half their cost, and drastically reduce its output next week for want of money, or money must be supplied from some source that has nothing to do with the production of Batch C.

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there may be less or more, and the difference is vital to Household Goods, and ultimately to all producers and all consumers.

How a change in the volume or cost of Batch D compared with Batch C may be caused will be examined later. Meantime it must be observed that, although we make no error of principle by confining the cycle of operations to two comprehensive companies, we greatly reduce whatever complications may be caused by the factor of time.

For Household Goods and Factory Supplies are in reality not each one company but many; and if we take a single factory of the Household Goods species, producing a simple commodity like boots, it may be true that all the work done by its own staff on the goods in its storeroom on Saturday morning may have been begun and completed within a week; but it is certainly not true that the work contributed by other organisations was completed and the wages paid within the previous week. The leather may have been tanned a month ago, the hide prepared a year ago, the thread grown three years ago, and the machines constructed five or ten years ago. All those tanners, planters, engineers and so on cannot be supposed to have kept part of their wages months or years till Batch C came to market. The money that is to buy Batch C must come from somewhere else.

Is this the Douglas theory? It would take us too far afield to answer that question now, and the reader who is interested may refer to a later chapter, though we should prefer him to read that in its proper place. Here we shall take our own course, and continue our

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inspection of the two factories. This afternoon, or at any rate during the next few days, Household Goods will empty its store-rooms and withdraw from the public £2,000. Half of this will be saved to pay its own costs next Saturday, and the other half will be remitted to Factory Supplies in return for Batch D. Let us amend our diagram to illustrate these changes, supposing them all to take place during Saturday.

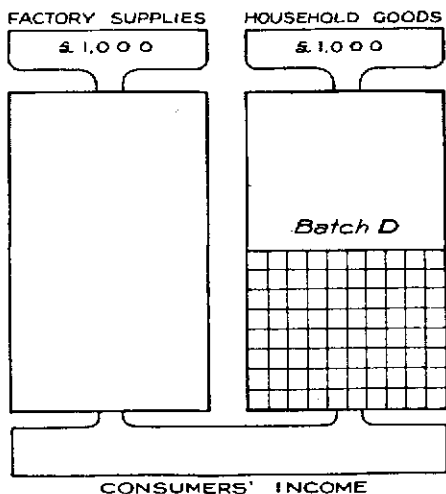


FIG. 2.—The consumable goods have been sold. The consumers have, therefore, parted with their money, and the semi-manufactures have been taken over for conversion into consumable goods.

This at any rate is what will happen if the cycle is allowed to continue. The passage of goods through their various stages, from production to consumption, is effected by the circulation each week of £2,000. We need not inquire who originally owned or supplied this

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£2,000. During its circuit it belongs to different groups at different times. At noon on Saturday its ownership is divided among the whole body of people, who have earned it as producers. They now, in the capacity of consumers, begin buying goods. Thus, the money flows back to Household Goods in exchange for commodities, and as soon as the commodities are distributed the £2,000 belongs to Household Goods. But Household Goods must pay half this sum to Factory Supplies for its weekly batch of half-finished goods. Thus, at the end of the week each factory again has £1,000 with which to pay its staff.

So long as this supply of money remains constant and circulates freely, being spent on goods by consumers as soon as they receive it and on further production by producers as soon as it returns to them, the flow of goods will proceed unhindered, and changes in price can only be caused by changes in the volume of goods. These may occur through improvement or deterioration in industrial efficiency, or through loss or gain in natural resources; they cannot, in the circumstances supposed, arise from monetary causes.

Now we will disturb this stability. Disturbance may be caused in two ways: the consumers may refrain from spending a portion of their income, or the amount of money in circulation may alter. These two factors operate at the same time in practice, but we shall find it more convenient for the present to deal with them separately, first confining ourselves to alterations in the volume of money. To do this we shall introduce a bank.

For safety and convenience Household Goods, Ltd.,

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deposits its daily takings from the sale of commodities with a bank, and £2,000 stands to its credit by the end of the week. Half this sum it draws out to pay its staff, and transfers the remainder by cheque to Factory Supplies, by whom it is likewise drawn out and distributed. If we assume that this money is legal tender currency, fixed in amount, and that nobody will accept any other form of payment, then the creation of bank credit, except for impracticably short periods, is impossible.

But let us now, while still for simplicity's sake supposing that all payments are made weekly, permit some of them to be made by cheque, and assume that the more opulent members open accounts with the bank. Their salaries or dividends are paid by weekly cheques, and they in turn pay for the goods they consume by cheques drawn in favour of Household Goods. Thus we find that the £2,000 does not to the very last penny leave the bank every Saturday. Some of it remains there permanently. But a number of changes take place in the bank accounts: once a week Household Goods and Factory Supplies have nothing whatever to their credit, while various private accounts have quite a lot. As the week goes on the private accounts diminish and Household Goods' account grows fatter. Once a week, also, the actual cash held by the bank is suddenly reduced by withdrawals for wages, but there is always some in hand, and the amount increases as the week proceeds and people spend their earnings.

One day it occurs to the manager of Factory Supplies that the resources at his command are not being fully

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used. Some of his machinery is occasionally idle ; certain estates at present virgin might be made to yield raw material ; all that is required is more labour. The labour, he happens to know, is available. Perhaps there are workers unemployed ; possibly a younger generation is now old enough to start work ; or the existing staff may agree to work overtime. But in whatever way the extra labour is provided it must be paid for.

The means of payment might be provided in more than one way ; for the present we shall suppose that it comes from the banker. He is willing to make an advance ; he can do so, as we have seen, merely by writing figures in his books. Some weeks may elapse before the fresh labour employed produces saleable results ; meantime, he is ready to issue credit to Factory Supplies week by week, starting in the first week with £1,000. (We may as well have a figure large enough to be seen and easy to manipulate.) Let us suppose that, for convenience, Factory Supplies forms a new company to utilise this credit and carry out the desired developments. The new company may be called Developments, Ltd., and we shall treat it henceforth as a separate entity.

The first week of the new era comes to an end. Household Goods has completed the production of Batch D, which is now on sale, and in volume and cost exactly equals all preceding batches. During the same week the original Factory Supplies unit has completed the first stage of Batch E, which is ready for dispatch to Household Goods. Developments, Ltd., has devoted itself to making new tools, sinking shafts, felling trees,

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and similar tasks in readiness for the new productivity which, as yet, has nothing to offer consumers. The position is shown in Fig. 3.

The cost of Batch D was, as usual, £2,000. During the week which saw its completion the two original

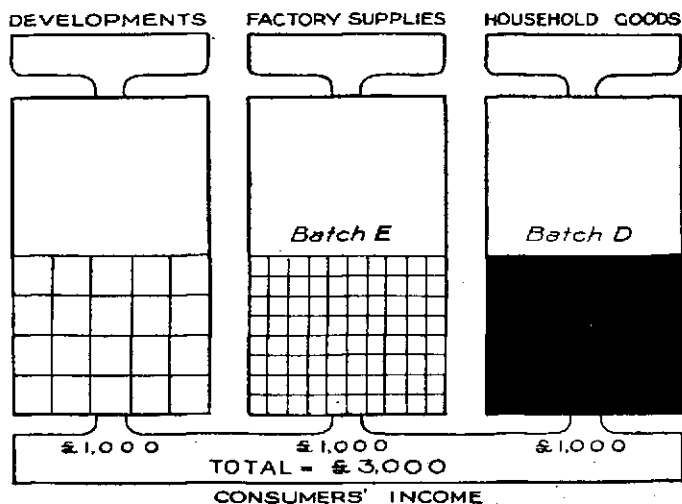


FIG. 3.

factories have each distributed £1,000, but Developments, Ltd., has distributed an additional £1,000. Thus, instead of the usual £2,000 of money ready to be spent on Batch D, the consumers have £3,000. What is going to happen ?

In a small community with conditions as simple and, until now, as static as we have described, one would expect Batch D to be sold at the customary price, £2,000, leaving the consumers with £1,000. We know,

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however, that in the larger and more complicated communities of reality, responsive by long practice to influences that have never before affected our idealised one, this is not what will happen. The price of Batch D will rise. If we suppose this batch to comprise 2,000 tons of goods, sold hitherto at £1 per ton, thus realising £2,000, its price will now be 30s. per ton, thus withdrawing from the consumers the whole £3,000 they have earned.

Such arithmetic may look a little too neat to be plausible ; and it is true that the Quantity Theory does not work with quite such exactitude or rapidity. But let us apply a similar expansion of credit to a modern industrial state in which production goes through many stages, in a large number of factories, resulting in a great variety of commodities sold in a multitude of shops. Let us apply it, in fact, to England.

A credit expansion suddenly adding 50 per cent. to existing purchasing power is certainly too wanton. Without troubling ourselves with the exact sum, our figures being of course only symbols, we will suppose that credit is certainly expanding rapidly ; the new money is flowing through sundry channels, all leading to an improved industrial equipment. Factories are being enlarged, old plant is being scrapped for new, raw materials are ordered in increased quantities, unemployed workers are being engaged. In time our industrial units will be more efficient ; in time they will produce more consumable goods—but not yet.

At once, however, we have more purchasing power. As soon as the new money begins to be issued it passes into the hands of consumers. The purpose of its issue

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may be a new ship that will not carry a single ton of goods for eighteen months. But *within six days* the money begins to flow into the pockets of those engaged upon the work, and the flow continues week by week.

On what will this money be spent? Obviously on goods already made, and on those coming into being week by week at a rate no faster than the maximum capacity of the existing productive organisations. The public has more money to spend; shopkeepers get rid of their goods more quickly than usual and increase their orders; wholesalers pass on the demand to manufacturers, meantime taking the liberty on their own account of raising the prices of any commodities already getting scarce, if they are of a kind in which a customary price is not too well established. The manufacturers, glad enough of urgent orders from merchants, begin to find a difficulty in getting deliveries of raw material. Expecting prices to rise in consequence of the evident shortage, they raise the prices of their existing stocks, and find the competing merchants, still bombarded with orders from retailers, perfectly willing to pay. A new level of prices has been reached.

Who among the various parties handling the goods first raises the price does not here matter; experience tells us that it certainly will be raised, and that the increase will be passed on, growing rather than diminishing as it passes.

Our illustration, then, exaggerated though its dimensions may be, is essentially true to life. The community, by increased effort, has raised its earnings by £1,000, but derived no benefit. The incidence of

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the hardship will depend upon how the new labour engaged by Developments, Ltd., is provided. If by workers previously unemployed, these are certainly better off than they were before, and their only complaint will be that a full week's wages buys less than they had always thought it did ; at the same time their more fortunate companions who have been working continuously will have experienced no change in their working hours, but a reduction in the purchasing power of their wages. If, on the other hand, there are no unemployed to call upon, the whole body of workers will have worked overtime without any real reward.

A movement of this kind once started does not immediately stop. As a rule it goes on for years, during which credit expands gradually and prices gradually rise. But it is not only the price of consumable goods that will rise. Certainly that is how the movement began ; the directors of Household Goods saw themselves able to exact a small extra profit by raising prices when the credit expansion started ; and we can suppose them to pay larger dividends for some time. Theoretically they may profiteer so successfully that the whole of this windfall goes to their shareholders, who will then be able to buy a larger share of the consumable products than they did formerly, and, since those products have not yet increased, the non-shareholders will suffer.

But these would demand higher wages to compensate for the higher prices, and their demands will in time have to be partly satisfied. The higher wages would affect Factory Supplies, who would promptly raise prices against Household Goods, not only to meet their bigger

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wages bill, but to secure some of the increased profits. We therefore see £3,000 circulating through the system in the same way as £2,000 formerly did, and as we shall continue to lump together all payments to individuals we need not concern ourselves with any changes that

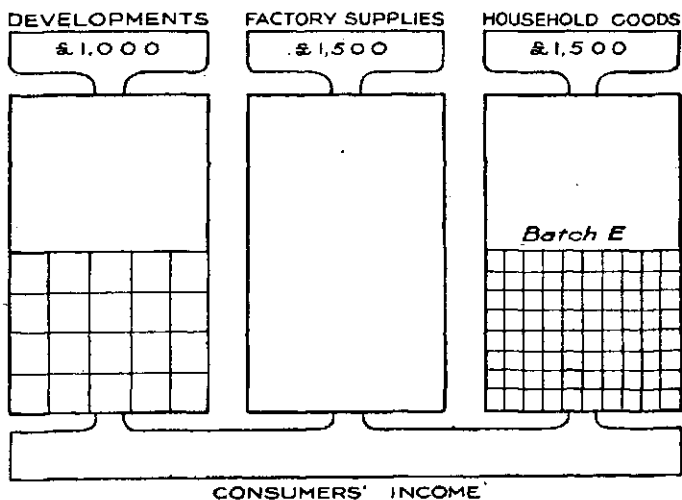


FIG. 4.

may have occurred in the proportions of wages and profits.

The reader may remark that as some of this new money, no matter how much, is profit, it may be re-invested, either by Household Goods or by the shareholders who receive it as dividends, instead of being spent directly on consumable goods. This is true; and it is also true that the original expansion of its resources by Factory Supplies could have been financed

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wholly or partly in the same manner; but as the introduction of investment here would complicate our figures without invalidating any of the conclusions we shall draw from the behaviour of bank credit it will be better to isolate credit and deal with investment in a separate chapter.

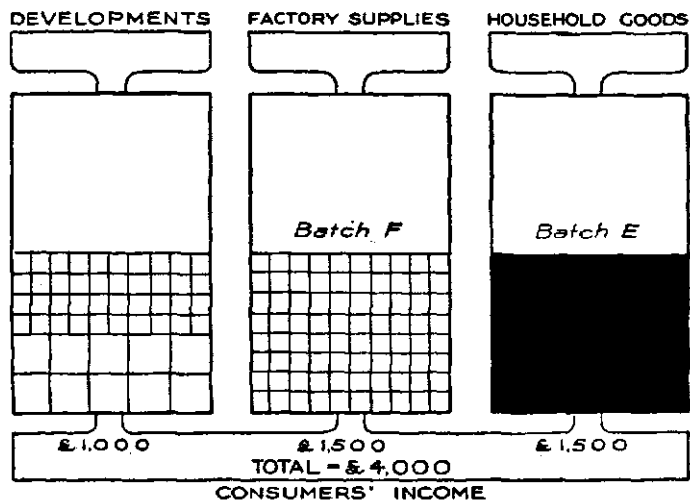


FIG. 5.

Bearing in mind that both the credit expansion shown in Fig. 3 and the changes in the distribution of money about to be shown take place more gradually than it is practicable to illustrate, the situation on the Monday morning when we resume our observations is shown in Fig. 4, page 72.

Household Goods has sold Batch D for £3,000, and taken over Batch E from Factory Supplies at the price

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now ruling, £1,500. Both factories now have £1,500 with which to do the work that £1,000 used to do. Developments, Ltd., must again rely on the bank in order to carry on, and receives a further advance of £1,000. Thus, at the end of the period, £4,000 in wages

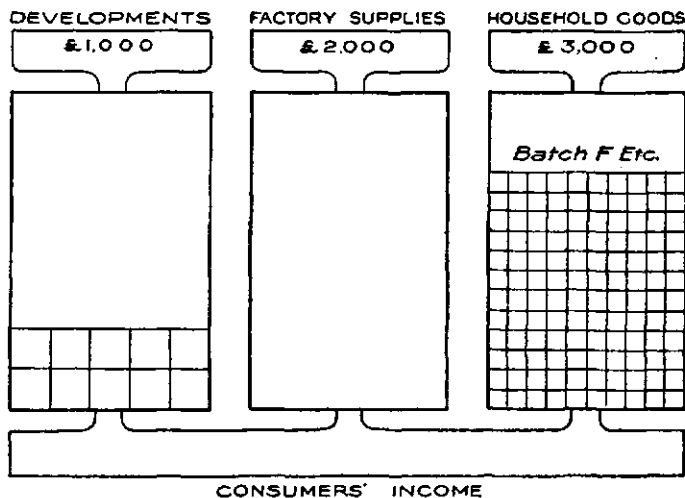


FIG. 6.

and profits is in the hands of the consumers. (See Fig. 5, page 73.)

Prices go up once more, for the £4,000 is absorbed by Household Goods for Batch E. Factory Supplies has now every reason to demand £2,000 for Batch F, since the demands of wage-earners and the expectations of shareholders have once more been raised, and the two original factories are left with £2,000 each. But the position of Developments, Ltd., we may now

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suppose, has changed. A little of its raw material, or whatever it may be, has reached a stage that renders it useful to Household Goods. The price of this portion is £1,000. But Household Goods requires all the money it has left to complete Batch F; it must borrow from the bank—not only £1,000 to buy the

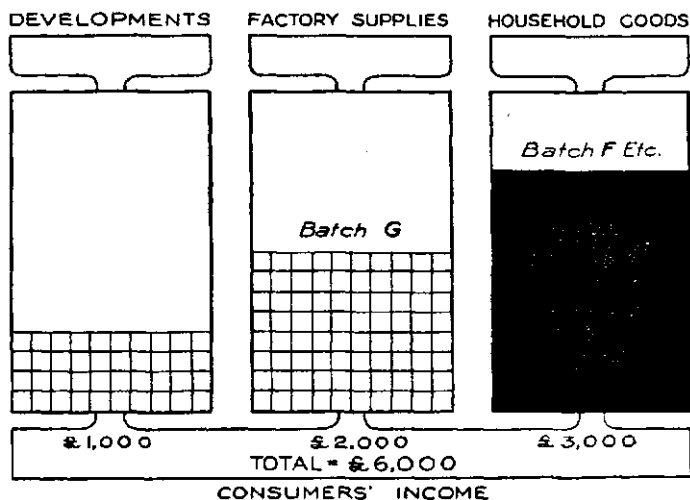


FIG. 7.

new material but a further sum, say £1,000, with which to work it up. Very well; £2,000 is advanced by the bank, and half of it is transferred to Developments, Ltd. Fig. 6 (page 74) shows the position after these exchanges are completed, but before the week's work is started.

Developments, Ltd., at last has money acquired by the sale of its product; it has received a cheque for £1,000 from Household Goods. The fact that this sum

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was itself borrowed from the bank by Household Goods does not affect Developments, Ltd. Still, Developments owes the bank £2,000, and if the banker requires this loan to be diminished by the sum its debtor now has, Developments, Ltd., cannot develop any more. The banker, however, waits, and all these units carry on, with the result shown in Fig. 7.

The consumers now have £6,000 to spend, but the quantity of goods they will receive in return has at last increased. Does this mean that prices will not this time go up? The answer obviously depends upon the exact amount of increase which has taken place in the volume of goods now seen in Household Goods' warehouses. An increase of 50 per cent. will keep prices where they were last week (for only £4,000 was then charged for the week's output). A larger increase will bring prices down, and a smaller increase will permit them to rise. The reader must not be deceived by the fact that 50 per cent. appears to be the amount of increase in our illustration; this represents the increased cost, not the increased volume of goods. The connection between costs of production and volume of output is very far from an exact one, and it would not be at all untrue to fact to suppose that a policy of increasing productivity were pursued for a considerable time without inducing a sufficiently increased output of consumable goods to prevent a rise in retail prices. It is a constantly recurring phenomenon in industrialised states.

Our crude little diagrams, with their blocks of goods suddenly appearing and vanishing and their sums of money issued and spent in the twinkling of an eye need,

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we confess, to be studied with imagination. It is better to think of the factories as connected and the goods as fluid; the goods pass in a constant stream from one factory to the other and out to the consumers. The level of the goods shown in the warehouses indicates the rate at which they are flowing, and the sums of money the rate of expenditure. The money flows through the productive system as costs, inducing production, flows back as prices, inducing consumption and absorbing the goods. Above this system is a reservoir of additional money, called credit, which can also be directed through the productive system, stimulating the output of one kind of goods or another, according to the part of the system to which it is applied. The greater part of any new money so liberated begins to reach consumers literally—not merely diagrammatically—within a week; but the goods whose production it evokes may take months to attain consumable form.

We started our system with £2,000; £6,000 is now circulating. But two-thirds of this sum belongs to the bank. Let us see what happens if the banker begins to withdraw it.

Household Goods sells its output for £6,000. Assuming that because of the increased productivity now being utilised this sum represents no real increase in prices involving further actual or prospective rises in costs, Factory Supplies will be content with £2,000 for Batch G. Developments, Ltd., requires £1,000 for the portion of its output now ready, and Household Goods is left with £3,000. Since this is the sum required to work up the new material and Batch G, the directors

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persuade the banker to wait a little longer for repayment of his loan. He agrees ; but is not so lenient with Developments, Ltd. This concern owes £2,000, half of which is sunk as fixed capital. In liquid form it has at the moment £1,000, and needs the whole of

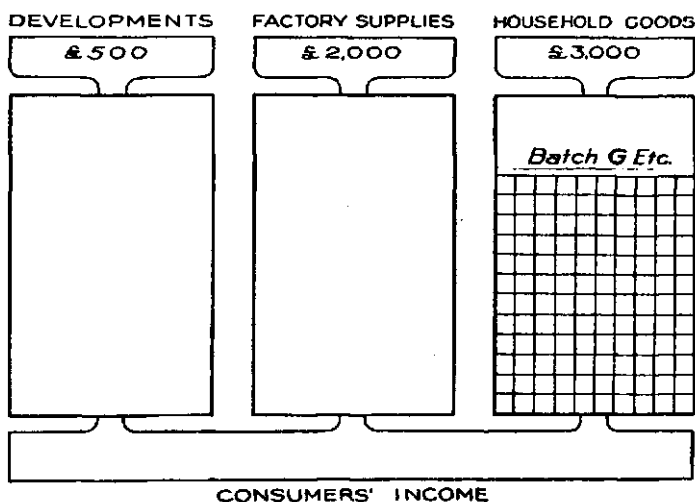


FIG. 8.

this if its present rate of production is to continue. The banker, however, demands £500, which is cancelled in his books. Developments, Ltd., must now discharge much of its staff and consequently curtail its output. The position at the beginning of the week is shown in Fig. 8.

It is important to remember that Household Goods has paid £3,000 for the semi-manufactures it has just taken over, and is about to pay out another £3,000 in

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working them up. At the same time the other two organisations will issue between them £2,500, making the consumers' income for that week £5,500. Therefore at the end of the week only £5,500 is available to purchase the commodities that Household Goods has ready. Their price must consequently come down. It is useless for Household Goods to argue that they cost £6,000 to produce. The statement is true, but the money is not in existence to buy them at that price; and if out of its reduced revenue Household Goods, Ltd., is called upon to repay some portion of its bank loan, then its ability to buy semi-manufactures will decline and further unemployment follow.

But since the community has shown itself capable of production at the higher level why should it now cease to utilise its capacity, and by this abstinence enforce idleness and want upon many citizens who would prefer to be employed? For we must remember that an expansion of productive capacity such as that described is not made possible merely by an increase of money but by a growth in population, and that this growth in population makes an expansion not only possible but necessary.

The picture we have painted is admittedly distorted, not only in its proportions, but in the omission of the effect of monetary saving. The proportions do not matter, and the omission is made good in a later chapter. Even by itself, however, what we have given is a true account of the consequences of changes in the volume of credit, and the other factors merely modify or disguise these consequences.

CHAPTER VII

THE TRADE CYCLE

THE process described in the greater part of the preceding chapter is called an inflation of credit, and the reverse process a deflation. There is no agreed definition of the term inflation ; one economist thinks it may be quite conveniently applied to any increase of currency of which the speaker disapproves, and is therefore a term of abuse ; it is tending, however, to denote an increase of credit sufficient to raise prices. It might be thought that any expansion of credit must be inflationary in effect, since the consumable goods whose quantity it is designed to increase can hardly be ready for sale as soon as the new money reaches the public, which as wages and salaries it begins to do within a week.

This is theoretically true ; but several factors tend to permit an expansion of credit to proceed for some time before the recognised signs of inflation appear. First, prices do not as a rule rise at once. We have already seen that custom plays a part here. Prices seem to obey a law similar to the law of inertia in mechanics ; it is not so easy to set them moving as to keep them moving once started. Moreover, there is usually an accumulation of goods in stock to be sold

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before a scarcity begins to be felt. Secondly, by stimulating demand the inflation may bring into use equipment previously idle. Thirdly, improved machines embodying new inventions sometimes quicken output to an extent quite disproportionate to their cost. Any such that come into use during a period of credit inflation tend to diminish its effects. Fourthly, increased production can occur without proportional increase of capital expenditure, by means of better organisation, or the removal of discontent, or any other incentive to effort.

These last two factors, it is true, may be said to disguise inflation rather than prevent it. Prices may for a time fail to rise ; but had no credit expansion taken place they would have fallen.

The characteristics of credit inflation are rising prices, the reduction of unemployment, and general industrial activity. Following a period of depression, an inflation presents itself by comparison as a period of prosperity, though the prosperity is not shared equally by all classes. Inasmuch as they are more fully employed, the wage-earners and salariat benefit, but those who remain unemployed are rendered worse off than ever by rising prices ; so are those whose income takes the form of pensions, annuities, and other payments fixed in amount. The same cause reduces the purchasing power of those employed. These press for higher wages, and eventually get them ; but always their wages lag behind prices, which rise still further as the higher wage-bill increases costs of production.

This introduces one of several interactions which our illustrations did not reveal. To examine these

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we must split up Factory Supplies and Household Goods into their many component manufacturing and distributing units.

The inflation is started, we may suppose, by substantial credits granted for constructional works carried out by organisations considered sound enough to make a financial success of them. At once money begins to flow to workers, and to be spent. (Many of them have been unemployed or working short time ; they are not likely to start saving yet.) The shops find trade brisk, and increase their orders, and the wholesalers pass on these orders to manufacturers. The manufacturers who receive these orders are, in the main, those who directly manufacture goods for private use and consumption. From these the stimulus passes to a great variety of units supplying raw material, half-finished goods, and machinery. To whom do these transfer the pressure in turn ?

To each other. The manufacturer of lathes and milling machines requires more steel and bronze and coal than he did ; the collieries require more trucks and pit-props, the steel-smelters and the ironfounders more tools and crucibles and coal. Wherever these growing demands diminish stocks a small rise in price tends to take place, and many such rises make a bigger one when added together in the price of the final product.

Observing the rising tendency, manufacturers and merchants increase their orders on each other, hoping to enlarge their stocks before prices go still higher. This action helps to bring about the anticipated further rise.

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A credit expansion, then, no matter to what segment of the industrial circle it may be applied, tends to affect all of it, just as air pumped through a valve at one point only on the circumference of a motor tyre inflates the whole tyre. But it acts in another way as well.

A manufacturer whose plant for some time has not been fully employed, finding now a growing demand for his goods, naturally wants to use his idle equipment. He buys more raw material and increases his staff. To do this he must borrow money, for he will have to pay wages and probably some of the bills for raw material before he receives payment for any finished goods. He overcomes the difficulty by obtaining a credit from his bank. Similarly, a wholesaler whose stock is inconveniently low for the volume of orders now reaching him from retailers, and who observes that rising prices do not seem to check the growing demand, is willing to hold much larger stocks than before, especially as their price seems to grow while he is holding them. He, too, seeks credit from his bank, for the purpose of ordering and holding larger supplies.¹

The banks have no reason to refuse these loans. They are required to meet a genuine demand for goods, and to grant them promotes production, and in the main hastens distribution. To refuse them, moreover,

¹ Mr. R. G. Hawtrey attaches considerable importance to the position of the wholesaler. See his *Currency and Credit*, Chapters II and IX, and *Trade and Credit*, pp. 98 and 99. (In writing this chapter, I have drawn freely from Mr. Hawtrey.) See also Professor Pigou's *Industrial Fluctuations* (2nd edition), p. 265

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delays the repayment of other loans granted to manufacturers earlier in the productive circuit. These must sell their output before they can repay the bank ; they cannot sell if other makers and dealers are unable to buy.

Finally, rising prices themselves call for more credit, since a manufacturer must pay more for labour and material on a given output.

Thus, an expansion of credit applied to any part of the industrial field tends to create increased demands for credit elsewhere, and these demands are not likely to be refused. The productive activity that is stimulated leads to a larger output of goods of all kinds ; some are of immediate use to the ultimate consumer, others do not directly satisfy any need of his, and some have so remote a connection with his requirements that years may elapse before he derives any advantage from them.

Why does a movement of this kind stop ? Why is it invariably followed by a movement in the opposite direction—a contraction of credit ? These questions, especially the second, have no simple answer ; in fact, they are still the subject of investigation and controversy. Our present purpose, however, is to see what happens rather than why, though we can at any rate glance at the reasons why a credit inflation cannot go on unceasingly.

It must obviously stop when industrialists can no longer use borrowed money profitably. If every fit man is employed and every machine working up to its capacity, no amount of borrowed money can quicken production. This condition, however, is

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seldom or never reached. Before that happens other causes are at work.

We have seen that the reason why banks can create credit at all is because many payments can be made without cash. People pay bills by cheques, and the cheques are not cashed but paid into bank accounts, involving no movements of currency. But not all payments can be made in this way. It is still customary to pay wages and the smaller salaries in cash, and although this cash soon returns to the banks it must be in existence, and it must leave the banks for a time. Anyone who has a bank account has the right to draw out in cash all the money in it, and almost every loan made to a manufacturer is bound to involve a withdrawal of some cash.

Now bank loans can be created easily enough ; they are merely book entries, as we have seen. But cash—that is, legal tender currency—is another matter. Whether it consists of gold or of paper notes, or of both, its issue is controlled by the Government and by the laws of the country ; the ordinary banks have nothing directly to do with it. They must, however, keep a certain amount of it in hand, and if the loans they have already made result in withdrawals of currency to such an extent that their cash reserves are reduced below the minimum they regard it necessary or prudent to hold, they will discourage further calls for credit by every means in their power.

A third check to credit inflation arises out of its effect upon foreign trade. We have seen that credit inflation causes prices to rise. This encourages imports from countries where no inflation is taking place. If

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a merchant in a foreign country finds that British buyers are paying more for commodities than his own countrymen are, he will acquaint British importers with the prices at which he is willing to ship goods. The importer realises that at these prices the goods can bear the cost of carriage and still be sold below the prices ruling in Great Britain. Simultaneously, British exporters who normally sell large quantities of goods abroad find that the prices they are now obliged to charge, owing to rising costs at home, deter foreign customers from buying. Thus we tend to buy more goods from foreign countries than we sell to them. This, in fact, is likely to result from inflation quite apart from changes in prices. For the home public has more money to spend, and some of it by the law of averages is likely to be spent on foreign goods. Before long we shall owe more money to foreign merchants than they owe to us. How are we to settle the debt ?

We cannot compel them to accept our paper money simply by calling it legal tender ; our currency laws cannot be imposed on foreign nations. They may accept our paper money, but not at its face value. We call a pound a pound, whether it takes the form of a currency note or a golden sovereign. Not so the foreigner ; he may call it 19s. 10*d.*—or the equivalent of 19s. 10*d.* in his own money ; and, for reasons which we shall examine later, one of the conditions likely to induce him so to undervalue the pound sterling is that very adverse balance of trade against us which we have assumed.

Gold, however, he will always accept at its face

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value. A gold sovereign contains a certain quantity of precious metal, which enables the foreigner to exchange it for gold coins of his own country containing the same quantity, or for the equivalent paper money or credit. No matter how the purchasing power of gold may fluctuate at home, its value in the gold money of foreign countries does not vary. Thus merchants who owe money abroad when the exchange is against us will settle their debts in gold, if the law allows them, and an adverse balance of trade tends therefore to drain gold from the country which suffers it.

An exodus of gold, however, is not at all to the liking of the banking Pharaohs. Gold is the rock upon which they have reared a huge mountain of credit. If it weakens, the mountain must be made lower lest it collapse.

In various ways their customers are discouraged from seeking further credit. First, the rate of interest they must pay is raised. This will discourage some more than others. The merchant whose stocks are already large may hesitate to increase them with borrowed money, not merely because the cost of holding them is higher, but also because he knows from experience that credit restriction is likely to mean that lower prices will follow. He may even try to anticipate the movement by clearing out his older stocks at reduced prices. The manufacturer with orders to fulfil may not respond so readily to a rise in the price of credit, though he may moderate his forward orders for material, and thus reduce the demands for credit made by others. If the rise in the rate of interest

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does not effect its purpose, it may be further raised, and the banker may discriminate among the applicants for credit. He may decline to renew loans to the less efficient capitalists; from others he may demand further securities which they are unable or unwilling to deposit.

The curtailed orders for goods lead to reduced employment. The flow of goods to the market does not diminish at once, but spending power does, and prices begin to fall. Thus the banks in a double way achieve their object; by issuing less purchasing power they reduce the demand for legal tender currency, as well as the amount of purchasing power spent on foreign goods, and by causing prices to fall they render the home market less attractive to foreign merchants, and so reduce imports. It is true that lower prices enable those who have any money to buy more goods, but prices are only low because money is scarce, and the first depressing effects of its scarcity cause those who have any to hold it rather than spend it. Traders will not buy goods which may fall in value before they can sell them; consumers will not buy goods they can do without when by waiting they may get them more cheaply still. This reduction in the velocity of circulation partly explains why a small stringency of credit can produce very great effects. Reduced orders from some merchants and manufacturers react on others, and a progressive decline in productive activity sets in, with that terrible increase in unemployment and in bankruptcies which are characteristic of a credit deflation.

The inflation that preceded it, fortunate though it

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was for many, proved a misfortune for those who had to bear the burden of high prices on a fixed income. The low prices ruling in a depression will benefit the same classes—but not necessarily the same people. Some of them will no longer be living; others may be living in changed circumstances. Those who have to sell goods bought when prices were higher suffer losses which they may or may not regain; those who gain by lower prices have not necessarily done anything to deserve it. People with debts to discharge pay more in purchasing power than they borrowed; creditors receive back more in terms of goods than they lent. Gains and losses both arise from decisions which those who enjoy or suffer them have had no share in making.

No principle of compensatory justice, in fact, can be discerned in the operation of the trade cycle. The benefits and the ills distributed in the boom are not balanced by those distributed in the slump. Neither is any mere economic balance maintained by the full use during the slump of all that new equipment built up during the boom; if it were, there would be no slump.

Now this strange rise and fall in economic activity, though it has reached extremes of height and depth between 1914 and the present time, is by no means peculiar to the abnormal conditions produced by war. It is a normal feature of modern industry, and economists have long been aware of it, though disagreeing in the theories by which they explain it.

One notable effect of the modern monetary system is the enormous increase in our instruments of production. Every boom brings vast additions to their

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number and efficiency. The additions are obtained, as we have seen, at the expense of the consumer. This is true whichever way we look at it. Either we may say that the effort which he has made as producer is wasted, so far as he is concerned, because he cannot consume machines and factories, or, if it be said that he has received compensation in money, the reply is that this also does not avail him, because the money is absorbed by higher prices long before the new machines can be productive.

We need not deny that some public benefit arises week by week and year by year from past improvements in industrial equipment, that some additional goods desired by the individual consumer reach the market and prevent prices rising as much as they otherwise would ; we may also agree that the growing demand during a boom quickens the production of goods for retail distribution. Nevertheless the fact that industrial effort tends to flow at an ever greater rate towards the increase of instruments of production is a manifest characteristic of modern industry.

We go into a modern store furnished with lifts, cash registers, and similar aids, and buy goods. The distribution of these goods has been facilitated by correspondence for which a typewriter was used. A typewriter is a machine made, perhaps a year ago, by another machine of quite a different type ; and this machine in turn is the product of still other machinery, as well as of various materials coming from mines, furnaces, and foundries at some unknown date. The most exhaustive research could not reveal how many works and workmen have co-operated to enable that

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shop to order our goods by a typewriter instead of the steel pen that would have served fifty years ago, or the goose-quill of a hundred years ago.

Thus a growing number of men devote their working lives to making implements whose purpose becomes ever more remote from the satisfaction of any human need or desire ; and this trend is encouraged by the industrialisation of other countries. Since these countries now manufacture for themselves consumable goods that formerly they bought from us, their requirements are no longer for these goods so much as for the machines with which to make them, or for the still more highly specialised plant required in engineering establishments—that is, they require not machines to make goods, but machines to make machines. To produce these vast and complicated tools the land has grown stuffy with towns, the towns clogged with factories, and the factories stiff with machines. The ultimate purpose of these is to supply us with the sort of goods we want for personal use, and they could do so in almost overwhelming volume ; yet something seems to hinder them. All this productivity we have, and so little product.

We try in our clumsy way to ignore the hindrance or to dodge it. The machines do eventually reach manufacturers and merchants who use them to make and distribute goods for personal consumption, and these gentlemen are not, as they proudly admit, in business for their health. They want to see their wares distributed. They employ well-dressed and eloquent men and women who study an art called salesmanship, which is the art of persuading us all to

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live in new houses with garages, to keep cars, to fill our rooms with beautiful furniture, to entertain ourselves with wireless sets and gramophones, to shave ourselves with half a dozen different razors and wash with a dozen different soaps, to eat more food, to drink more drinks, and generally to do ourselves as well as modern industry and commerce can show us how.

The only inducement they need to bring these delights to our doors is money. Now we earned money in making the very instruments that are now ready to produce them, but unfortunately that money has been spent, and will only be issued again to make still more goods and instruments. If some influential person decides that no more instruments of production are required because those already made have at present little to do, then they will have still less to do, for we shall earn less money with which to induce their owners to set them moving.

The production of goods, even of capital goods, does not, in truth, ever really cease; but the rate of production of these and of all goods may be reduced by the withdrawal of some of the credit which stimulated it. The fact that during the boom we amassed an excess of productive instruments does not, it seems, entitle us now to utilise their productivity at our leisure. Many have leisure in the sense that they are idle, but not in the sense that they have sufficient freedom from material care to lead a fuller life. The monetary system which compels us all to pay for the means to leisure and liberty does not permit us to enjoy them.

CHAPTER VIII

GOLD AND THE EXCHANGES

BANKERS and economists are not blind to the imperfections of our monetary system. Though unwilling to admit a fundamental defect, they yet realise that defects are there. Some appear to regard them as irremediable without unduly infringing the rights of individuals to freedom of choice and action ; others have remedies to propose.

All agree that sharp fluctuations in the purchasing power of money ought not to occur ; but this does not prevent those in control from pursuing a policy bound to produce this result if an object they hold still dearer seems to demand it. Such an object is the maintenance of our store of gold.

The responsibility for this rests with the Bank of England ; the ordinary joint stock banks are only indirectly involved. The Bank of England is a private concern, with important public powers and privileges conferred upon it by the Bank Charter Act of 1844 and other Acts. It works in close co-operation with the British Government, through the Treasury, and acts as the Government's banker. It also acts as the bankers' banker, holding cash balances for all

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the joint stock banks, whose capacity to issue credit largely depends upon the size of these cash balances, upon which they can draw if they find themselves getting short of currency. The chief purpose served by the joint stock banks' balances at the Bank of England, however, is to enable them to settle debts between each other arising day by day through cheques drawn by customers of one bank in favour of those of another. The bulk of these debts naturally cancel each other when balanced by the clearing house, through which are passed all cheques paid in to banks for collection from other banks; but some small differences remain, and these are adjusted by operating on each bank's reserve at the Bank of England.

As a rule, a bank which finds itself down one day on balance will be up the next; but if its customers steadily draw cheques in abnormally large volume, and a normal proportion of these reach customers of other banks, its balance at the Bank of England will steadily decrease. Such a result would follow if any bank issued appreciably more credit than the rest. For this reason among others all banks tend to expand or contract credit in concert.

The Bank of England is the custodian of practically all our monetary gold, whether coin or bullion, and controls the issue of our paper currency, subject to the law of the land. Our legal tender paper, as practically everybody knows, consists at present of ten shilling, one pound, and five pound notes. (Bronze and silver coins are legal tender only up to one shilling and forty shillings respectively; the quantity in circulation is negligible.) Our legal tender notes are based upon

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gold ; that is, their amount varies with the quantity of gold held by the Bank of England. This does not mean that when the issue of notes amounts, say, to 420 million pounds the Bank holds that amount of gold. It has the right to issue notes up to a certain total value uncovered by gold. This is called the fiduciary issue, and its amount at present is fixed at 260 million pounds.¹ Above this figure every pound note issued means a pound's worth of gold in the Bank of England. As gold is acquired by the Bank, notes may be issued ; as gold is withdrawn the notes are cancelled.

Why the joint stock banks are interested in the stock of gold held by the Bank of England will now be plain. The volume of credit they can create without producing heavier demands for cash than they can satisfy depends upon the amount of currency issued, and the amount of currency depends upon the stock of gold.

The Bank's reserve of gold fluctuates from two causes ; it may be increased by new gold from the mines, and it may be either increased or decreased by foreign exchange operations.

Gold from the South African mines is shipped to London nearly every week, and is there sold. Some is bought for industrial purposes by goldsmiths and others ; some is acquired for foreign and overseas banks. If any remains it is sold to the Bank of England, which is obliged by law to buy all gold offered to it, at the price of 77s. 9d. per ounce of standard purity (or just under 84s. 10d. per ounce fine, which is the same price expressed in terms of a finer

¹ Increased temporarily to 275 millions on August 1st, 1931.

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degree of purity). The Bank is also obliged to sell gold on demand at 77s. 10½*d.* per standard ounce, or approximately 84s. 11½*d.* per fine ounce, though it need not satisfy orders for less than 400 ounces. Every standard ounce of gold would be minted into coins equivalent to 77s. 10½*d.* in value if it were minted at all; thus it may be said that the value of a golden sovereign is exactly that of the gold it contains; the same amount of uncoined standard gold would be worth no more and no less.

Gold may be sent to this country through the foreign exchanges in settlement of debts when that proves the cheapest or only way of settling them, and leaves the country to pay our debts abroad in the same circumstances.

But debts between merchants in different countries are mainly settled by cancelling each other. Suppose once more, as we did in Chapter V, that you have sold machinery worth £100 to a Dutchman named Pieter, who has acknowledged the debt by a bill of exchange payable three months after sight. You have sold this bill at once, and will think no more about it. But eventually Pieter must settle it, no matter how many times it has changed hands in the meantime, and he or his banker have somehow to get £100 sterling to London.

Now suppose also that an Englishman named Thorp has bought cheeses worth £100 from a Dutchman called Steen, who has drawn against Thorp or Thorp's banker a three months bill which has now fallen due. The position is that Holland (in the person of Pieter) owes England £100, and England (in the person of

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Thorp) owes Holland £100. The account between the two countries balances. Thorp buys your bill (representing Pieter's debt to you) and remits that to Holland, and Pieter buys Steen's bill against Thorp and remits that to you. In effect, Pieter, who bought your machinery, pays Steen instead of paying you, and Thorp, who bought Steen's cheeses, pays you (or the man who holds your bill) instead of paying Steen. Your export pays for Thorp's import.

In such ways as this international debts to the extent of many millions of pounds are cancelled against each other every year, not indeed by merchants directly, but through their banks; and as many bills are drawn on London to effect sales between one foreign country and another, and as the principal banks in all countries have branches or agents here and keep sterling balances for convenience, a large proportion of these transactions are carried on in the London money market. Leaving out of account the effects upon sterling of the withdrawal or the augmentation of their balances by foreign banks, the stability of the exchanges between this country and the rest of the world depends upon the balance of trade, modified by loans.

So long as the value of our exports equals that of our imports no money has to leave the country; the goods we sell pay for those we buy. The term "goods" is used in a wide sense, especially where the trade of Great Britain is concerned. We render services to other countries for which they have to pay; our merchant ships carry their cargoes; our money market affords them credit; they owe our investors money requiring periodical payments of interest and

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dividends ; our insurance companies bear risks for them. These services are called invisible exports ; they are not goods, but they have the same effect as an export of goods in that they increase the indebtedness of foreign countries to our own. Reparations and war debts are, in effect, among the invisible exports of the countries to which they are payable.

If after all these things are taken into account the balance is still against us, the foreign exchange market soon knows it. An increased demand arises for the means of paying debts to some country to which, on balance, we owe more than we are owed. Now we know what happens to any ordinary commodity when the demand is great and the supply diminishing ; its price goes up. Exactly the same is true of a nation's money. If you want to pay a debt to a Frenchman when many other people are doing the same thing, you will have to pay a little more for the means to do so than you otherwise would. The difference is reflected in the rate of exchange between your country and the foreign one concerned. When you see the French franc quoted at, say, 124.00 to the £1 sterling, you know that (apart from small incidental charges) your £1 sterling will enable you to pay a Frenchman a debt of 124 frs. If on another occasion you owe him the same amount but find the rate 123.70, your sterling £1 is no longer sufficient ; the Frenchman would be 30 centimes short. To send him 124 frs. this time you must pay a halfpenny or so more than £1.

This will not dismay you if one small private debt is all that is involved. But if you are a banker, and have to settle debts for vast amounts, these small

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differences are of the first importance. Should they grow any larger you will seek some cheaper way of sending money to France than trying to buy "French exchange" which is scarce and dear. But can you do it in any cheaper way? Can you send money to France in any form different from these paper documents which have begun to cost more in English money than they normally do?

Yes. You can send gold, which is esteemed so highly that it is accepted in payment of goods or debts in almost every part of the world. In April 1925 England returned to an effective gold standard, and the restrictions previously imposed by law upon sending gold abroad were removed.¹ The pound sterling, no matter what quantity of goods it might buy, became equal to a certain definite quantity of gold; the French franc also (though not till a later date) became equal to a definite quantity of gold. The quantity of gold in the English pound is the same as that in rather more than 124 French francs. The par of exchange between England and France is expressed by this ratio: £1 = 124.21 francs. This means that if you send a pound in gold to a Frenchman you are sending the equivalent of 124.21 francs, no matter what the actual rate of exchange may be that day.

If, therefore, you find that in paper money, or other credit instruments, the pound sterling is only equal to 123.50 francs—or, to put it the other way round, to buy 124.21 francs, you must pay nearly £1 os. 1½d.—you will prefer to pay any large French debt in gold, and the only thing to deter you is the cost of shipping

¹ But see page 107.

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the gold and insuring it. These costs enable an exchange rate to fall a little below par without causing an export of gold. They vary slightly from time to time, but the rate of exchange we have supposed is sufficiently against the pound to render shipments of gold certain.

Such shipments, if continued, may reduce the Bank of England's reserve of gold to a level considered by the Authorities too low. Something must be done to raise it. One instrument used for this purpose is the Bank Rate, which is the rate charged by the Bank of England for discounting bills of unimpeachable quality.

The quality of a bill of exchange depends mainly upon the standing of its acceptor. We have already explained how bills are often accepted by banks and other institutions instead of the real debtor, who may not be very well known. Acceptances by London banks and accepting houses are the most highly honoured of all. Bank bills of the best quality will be discounted by the Bank of England at the official bank rate. Other banks and discount houses take them at a slightly lower rate: naturally they keep the rate as near to the bank rate as they can, in order to earn the greatest profit on their loans, and also because the bank rate determines the rate of interest they must pay customers who have deposit accounts with them. This rate is usually 2 per cent. below bank rate. The rate for the best bank bills determines the rates for commercial bills and others of lower quality, as well as that charged on credit advances of all kinds; but what those rates actually are depends upon the eagerness of borrowers and the quantity of money available.

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One other effect of a rise in discount rates—which is, of course, a rise in the earning capacity of loaned money—is to draw money hither from foreign financial centres, which find London a more profitable market. Thus remittances towards London suddenly increase, which is exactly what is wanted, the trouble having arisen through an excess of remittances therefrom. This, however, is regarded as a doubtful blessing. It increases our foreign liabilities, and the balances from abroad may again be withdrawn at short notice. Still, it affords ease for a time; and, apart from an actual influx of foreign money, foreign balances that were about to be moved may be left alone.

A rise in the bank rate sometimes fails to restrict the flow of credit to the extent desired; there is plenty of money about, and a wide gap exists between the official rate and that at which borrowing is actually taking place in the money market. The Bank of England may then avail itself of its prestige and request the banks to assist in making the official rate effective; it "takes the market into its confidence," and the result is a fractional rise in money market rates which curbs the eagerness of many borrowers and reduces loans. Or it may sell securities. The Bank of England holds a large stock of first-class securities, for which there are always buyers at a price. The buyers pay for them by cheques drawn on their own banks—and thus the money held by these banks is reduced; the "Hidden Hand," in the jargon of the money market, has been at work. The reduction is seen in the reserve which each of the joint stock banks keeps at the Bank of England. They regard this reserve as

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cash: it is cash in effect, because they may make withdrawals from it in the form of legal tender currency; and since its amount determines how much credit they may prudently issue, a reduction in the reserve must involve a withdrawal of credit.

Similarly, if the tendency is in the opposite direction, and the gold reserves are increasing, or for any other reason the Bank of England regards an expansion of credit as desirable, it may lower the bank rate, and supplement this action if necessary by buying securities, the accounts of the sellers, and therefore the reserves of the banks, being swollen by the sums it pays for them. This, indeed, can no longer be regarded as a last resource. The purchase and sale of securities by the Bank of England—its "open market" operations, as they are called—form an instrument for the control of credit which has been much used since the war.

Movements in the price and volume of credit have a rapid effect on the money market, and one almost as rapid on the investment market. Speculative buyers and sellers of securities and commodities react promptly to monetary changes, not only because of the direct effect upon their profits, but because the more mercurial among them see each movement as a tendency which they compete with each other to anticipate. Upon industry the effect of a change in banking policy is not quite so rapid; how vast it is, however, we have already seen.

A few simple operations initiated by the Bank of England, then, produce results of startling magnitude. Many people seem lost in admiration at the almost unflinching certainty with which a simple cause thus

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leads to a simple effect through a most intricate series of subsidiary phenomena. The automatism of these processes seems to them a thing of beauty.¹

Automatism can certainly be both useful and fascinating. Motorists have long desired a simple method by which a tyre can be automatically inflated as a car runs ; they would not be impressed by a device which alternately inflated their tyres to bursting point and deflated them to flatness. Since that is the way our credit system works, it is not surprising that proposals are being made to replace its automatism by control of a more intelligent kind.

The present system stands condemned not because it fails to achieve the object of its controllers, but because it achieves so much more. Their professed object is to safeguard our gold while allowing anybody to buy and export it who finds it profitable to do so. "The meaning of a gold standard," writes Mr. R. G. Hawtrey, "is that credits are exchangeable for gold and gold for credits at a fixed rate (or at fixed rates differing only fractionally)," and its chief merit, according to Professor Pigou, apart from preventing anti-social currency manipulation by Government, is that the exchange with other gold standard countries "cannot fluctuate outside the narrow limits set by the import and export specie points." What advantage this has worthy to be set against the terrible evils resulting from its establishment and maintenance one finds it hard to discover. Certainly a merchant knows

¹ The Macmillan Report (paragraph 218) describes "bank rate policy" as "a most delicate and beautiful instrument" for its purpose.

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that a debt payable in foreign money at some future date can only fluctuate fractionally in the money of his own country ; but a similar result was achieved by the development, during the years when the gold standard did not operate, of dealings in forward exchange, which enabled a merchant to transfer the risk to his bank or the money market. And the immunity he now enjoys is only an apparent one ; the figures by which his foreign debt or credit is expressed cannot appreciably fluctuate, but its value in goods can, through changes in price. In the controversies on the gold question that followed the war the two policies of exchange stabilisation and price stabilisation were frequently opposed to one another. The exchange stabilisers have had their way—and all the predictions of those who opposed it have been only too accurately fulfilled.

That these results cannot have surprised even those responsible for producing them is evident. The Cunliffe Report on Currency and Foreign Exchanges referred complacently to “ a consequent slackening of employment,” with a diminished demand for consumable goods, as an effect of the means necessary to restore a disturbed equilibrium to the system which it proposed to re-establish. Mr. J. M. Keynes, commenting on this in his “ Tract on Monetary Reform,” published in 1923, was inclined to moderate his criticism on the ground that the report was produced before the end of the war, when the conditions that followed peace might not have been all foreseen. But the policy was pursued with the utmost ruthlessness ; the warnings of such economists as Mr. Keynes,

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Mr. D. H. Robertson of Cambridge University, and Professor Cassel of Sweden were unheeded; not only was the gold standard precipitately restored, but the pound sterling was brought back to its pre-war parity, which is no necessary condition of a gold standard, as France was wise enough to realise.

No country can ensure by its own action that a gold standard system will work in a way satisfactory to itself. That is a lesson which we have learned to our cost during the last few years, if we did not know it before. In pre-war practice a country receiving gold through favourable exchanges used the gold as a basis for credit expansion. This stimulated a demand for goods which, being partly met by the country losing the gold, would turn the balance of trade in favour of that country and restore equilibrium to its exchange. But if a country attracting gold buries the gold in vaults as fast as it flows in, the disequilibrium either remains uncorrected, or must be corrected by more drastic action in the debtor country than would otherwise be necessary. We have learned to do without gold for money, yet we are penalised if other nations hoard it; because the world can only produce some eighty million pounds worth of gold a year, our industries must cease producing things of far more use.

A curiously top-heavy position is now occupied in our economy by the money market. London became an important financial centre through the efficiency and success of British industries. Because we developed so vast a trade with the rest of the world, our money market became the world's counting-house. Therein are settled a large number of international debts, and

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because a dealer in debts can also create them, London issues short-term credit to foreign borrowers.

These operations, based on the prosperity of our industries, have become a little industry of their own. We derive a revenue therefrom. It is not a vast revenue compared with the national income, and in fact is small compared with the potential national income of unfettered productive organisations. Yet the interests of this pigmy have been made paramount ; for the good of its health the giant that gave it birth must be crippled and dust thrown in its eyes. I do not indeed regard our industrial captains as the mere innocent victims of an economic order that they would replace by a just one if they could, nevertheless they have had little to do with the financial situation that has been brought about in the last ten years.

Who is responsible for our monetary system ? Who benefits by it ? No Government received or sought a mandate to restore the gold standard. On such highly technical matters Parliament is obliged to trust its experts until their advice is seen to be unsound. The responsibility for our present monetary policy must be shared between the Treasury and the Bank of England, with the joint stock banks as accessories, willing or otherwise. Yet it cannot be said either of the Bank of England or of the deposit banks, as it can of our industrial capitalists, that their sole object is the profit of their shareholders. Certainly they reap substantial profits, in boom or slump ; but they could make bigger ones by adopting less conservative methods ; and it is by no means evident that their profits must be greater under a gold standard than otherwise.

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The truth is that the banking system is a bureaucracy, with the virtues and defects thereof. The characteristics of a bureaucrat are his unimpeachable loyalty to a system, his disinclination to change it, his comparative unconcern for the merits of the policy he has to administer, and his metallic and almost inhuman consistency in administering it, indifferent to criticism or consequences. Those are just the qualities to be observed in the administration of monetary policy during the last twelve years. The bankers are in charge of a system; a time comes when the system can be made to work in the intended way only by measures that impose sacrifices on us all. They take those measures, and decree that because they are virtuous there shall be no more cakes and ale.

The burden has now become too great. At the moment when this book is going to press the gold standard has been suspended. The Bank of England is not now obliged to sell gold at a fixed price, and in consequence the rates of exchange may fluctuate without limit according to the balance of current indebtedness. Since this balance is against us the pound will for the present fall. The intention, no doubt, is to stabilise it again later at a lower value; the pound will be worth less in gold and in foreign currencies. It is possible, however, that the question of whether any gold standard is worth while may be reconsidered.

Meantime, by these developments the measures proposed later in this book become not only easier to adopt but more imperative.

CHAPTER IX

THE PROBLEM OF THRIFT

So far we have written of the money which finances the creation, transport, storage and distribution of goods as if it not only originates with the banks but can only reach the entrepreneurs who use it directly from those institutions. Everybody knows, however, that enterprises are often financed out of the savings of private investors, who lend their money to manufacturers instead of spending it. This source of capital seems to differ in one important respect from that lent by banks. Bank credit increases the volume of money in existence, and its withdrawal decreases it. Money invested out of savings, on the other hand, does not change the amount in circulation ; it is simply diverted from one channel to another. What are the economic effects of this operation ?

Before proceeding, it may be as well to point out that not all the capital that appears to come from individual investors is really provided out of savings. Some of it is bank credit that reaches industry by an indirect route. A private investor who already holds securities of a thoroughly sound kind may wish to acquire an interest in some more speculative venture. Banks are

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not willing to finance such ventures themselves, but may be quite ready, if offered adequate security, to lend someone else the money with which to do so. The investor therefore deposits certain of his soundest securities with the bank—some Government stock, for example—and in return receives a considerable proportion of their value as a loan, which he invests in the new enterprise. For this the bank charges him, say, $5\frac{1}{2}$ per cent. He is willing to pay this rate because he believes the new venture will yield a larger return in dividends. If it does he is that much better off. If it fails entirely he must repay the bank from some other source or allow the securities deposited to be sold.

Capital raised in this way is obviously an addition to the volume of money in circulation ; it is credit, and has the same effects upon industry and prices as credit issued more directly. It will figure, of course, in the bank's returns among the advances to customers : it is not cited here as some new and undisclosed form of credit ; but one must bear in mind when considering the magnitude of the sums subscribed to new capital issues that these include, besides genuine savings, an unknown quantity of credit issued in this manner.

Nevertheless, much capital is provided out of individual savings. Fixed capital is, in the main, so supplied ; banks do not care to lock up money in building new factories and equipping them ; they prefer to provide the working capital needed to enable existing factories to execute orders and thus repay loans within a few months, though not all their loans are of this character. What are the consequences of investment out of savings, in distinction to those of

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credit creation? The investments with which the question deals are of course those in new issues; the purchase of shares in existing concerns simply moves money from one potential consumer's pocket to another's.

First we may note that savings about to be invested have already passed through industry once. The investor has received them either as earnings or as profit of one kind or another. If they followed the course we have hitherto described as normal, they would be spent on finished goods and services, return to the banks in settlement of various debts, and be issued again. Instead of spending them, however, the investor returns them directly to an industrialist to enable him to increase his means of making goods.

But the industrialist can only do this by spending the money thus received. Some is paid out directly as wages, some goes to other concerns who themselves pay it out in wages. In this way it does, after all, get spent on goods and services by consumers, just as though the investor had spent it in that way himself. The volume of money in circulation has not altered; does this imply that the investor's action has caused no changes in industry or prices?

Clearly it does not; for in the first place the branch of industry to which the money goes receives it sooner than it otherwise would, quite apart from the fact that it might otherwise not receive it at all. Even if the money goes to finance some stage in the production of the same kind of goods as those upon which it would otherwise all have been spent, direct investment is a quicker way of getting it there. Suppose that I have

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£400 to spend upon furniture, and that this furniture passes through four stages before it reaches my home, each stage adding £100 to the price, the four stages being : (1) Felling trees and sawing them into planks, (2) seasoning the wood and cutting it into standard sizes and shapes, (3) making the furniture, (4) selling it. My £400 if spent upon furniture will be received by the seller, who retains £100 for his own expenses and profit, and transfers £300 to the manufacturer, who passes £200 to the semi-manufacturer, and so on. If, now, instead of buying the furniture, I invest my £400 in the factory that seasons wood and roughly prepares it for final manufacture, whose owner wishes to enlarge his output, he receives £400 at least as soon as he would have received only £200 had I bought goods. (For only £200 of every £400 taken by the retailer passes through his hands.) He is thus able to employ more labour and to give larger orders to the timber merchant, or to buy new equipment for his own factory. If I continue to invest money in the same way, the timber merchant will continue to be stimulated by enlarged orders, and he may raise his prices. Meantime, my abstention from buying furniture will not help the semi-manufacturer ultimately to sell his increased output. We must presume that he felt sure of finding a market somewhere for it before soliciting new capital. If he proves mistaken he will eventually find himself over-capitalised.

My investment, then, resembles those creations of credit that stimulate productive activity at stages anterior to that of marketing consumable goods ; but, since the money in the hands of consumers is not increased, it does not, like a creation of credit, raise

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retail prices. On the contrary, it tends to lower them.

For though my money eventually reaches consumers it can only do so after some delay. I must have curtailed my own expenditure for some little time while saving enough to invest ; and if a sufficient number of people change their habits in the same way, that is, by saving money they had hitherto spent, shopkeepers will find unsold goods left on their hands unless they lower prices to get rid of them. Quite apart from delay for purposes of accumulation, any increase of investment out of income involves immediate abstention from consumption, and would reduce the prices of consumable goods at once if economic responses were automatic and instantaneous.

But it is the saving that thus produces this effect, not the investment. Because investment presupposes saving, and because saving is normally followed by investment, the two are not always sufficiently distinguished. They are separate processes, and achieve their effects in different ways. It is not investment that reduces demand and in that way lowers the price of consumable goods, it is saving ; and not merely saving, but an increase in the rate of saving. A certain minimum of saving may be regarded as normal. When you have a rich class that cannot possibly consume all its income, naturally a portion will regularly be invested. But a continuance of investment at a stable rate does not cause a change in the demand for goods. Such a change is caused by a change in the *rate* of saving ; people who have been spenders may become hoarders, and if the bank balances which consequently accumu-

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late are not made the basis of new bank credit the demand for goods will fall off and trade decline.

Let us return to the illustration used in Chapter VI, where Factory Supplies and Household Goods together distributed £2,000 each week and sold consumable goods to the same value. Now suppose that in a certain week the consumers, instead of spending £2,000 on household goods, save and invest £200 of it, and continue to do this each week thereafter. The demand for consumable goods is reduced by 10 per cent., and Household Goods must either reduce its prices or keep 10 per cent. of its output unsold. But goods cannot be held indefinitely, and sooner or later prices must fall till this unsold stock is unloaded, when they will return to their former level (in the absence of other factors), but with an output reduced to the level of the new demand.

It is important to note that neither of these effects is prevented by the fact that the £200 is invested, even if it be invested without delay. It is true that £2,000 in that case continues to pass through the productive system and thus to reach consumers each week; but we are supposing that the saving and investment of £200 weekly has now become a permanent habit of the consumers, and the consequence of this is that only £1,800 each week is withdrawn from them in prices by Household Goods, which must respond sooner or later by correspondingly reducing its wages bill and its output. So far as Household Goods alone is concerned, the effect would be exactly the same if £200 dropped out of circulation; it has, in fact, ceased to circulate through that particular unit.

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But the effect upon production as a whole is not at all the same as that of withdrawing £200 from circulation. For this sum passes directly to Factory Supplies, which is thereby enabled to absorb as much additional labour as Household Goods has relinquished, and to increase its output of instruments or semi-manufactures. There is thus no decline in employment or in output as a whole, but employment has shifted from some trades to others, and the production of capital goods has taken the place of that of consumers' goods. But since the purpose of capital goods is ultimately to produce consumers' goods, the result of these investments must eventually be an increased supply of consumers' goods apparently uncalled for.

One other interesting feature of this process may here be observed. The effect of saving upon the prices and output of consumable goods was seen to be the effect of a change. Admittedly the producers would not accommodate themselves to a turnover reduced from £2,000 to £1,800 without considerable loss and distress to individuals, but once they had done so they would reach a new condition of stability which would continue (apart from other factors) so long as the rate of saving did not again alter and £1,800 continued to circulate. But the effect of the investment, even at a stable rate, is cumulative. While £200 a week continues to be invested, goods of some kind will be piled up. They need not, it is true, continue to be unused capital goods. The flow of invested money may be diverted towards units which can take over machines and raw materials and use them for turning out consumers' goods. But since the money in circula-

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tion has not increased they cannot be sold—unless their prices are reduced. And reduced prices, as we know, are not under present conditions the unmixed blessing to society as a whole that they are to consumers as such ; and the stability of those producers who have newly accommodated themselves to a reduced demand will now be disturbed by increased supplies.

Suppose that investment has enabled more boots to be put on the market. In a state of pure communism this would be entirely an advantage : more people that wanted them could have boots ; though in a communist state an investment made in the manner assumed is difficult to imagine. In a society where industry was carried on by one vast private monopoly the result also need not be unsatisfactory : the monopolists would possess themselves of the consumers' money, as usual, but would give more goods for it ; though it is hard to see what could induce monopolists to provide more boots at all. (If they did, and people declined to buy them, the monopolists would remain in debt to the banks till they reduced their output and increased their prices.) But in a country where competition still to a large extent prevails the results are not quite so simple.

Some manufacturer applies his own and other people's savings to the making of boots. He has no special ground for thinking that the effective demand for boots is unsatisfied, or that it is about to increase. He merely sees no reason why he should not make boots as well as anybody else ; or perhaps he thinks he can make them a little better than anybody else for the same money. In any case he means to make them,

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and in due course is able to turn out a thousand pairs of new boots a week. With what money can they be bought ?

Nothing that he or his shareholders have done has increased the money available ; they have simply diverted its course. If his boots are better or cheaper than other makers' he will sell them until his competitors cut their prices, when he must cut his prices too. If the enlarged output of boots happens to coincide with an increased demand, then the whole supply may be sold with no reductions in price—but only at the expense of other goods which consumers must have abstained from buying. It is evident that when an enlarged output has to be sold for a given quantity of money, either the price of all goods must descend uniformly or that of specific goods must descend in varying degrees. But to reduce his prices does not confer upon a manufacturer the right to reduce the sums he owes for material or equipment. These must be paid though he has to reduce his staff. Moreover, the efficiency of different productive units is not uniform, and a very small reduction in prices will be enough to put some manufacturers out of business and their workers out of employment.

It might be thought that the decline in trade produced by a growth of savings prior to intended investment would discourage the savers from carrying their intention into effect. First, however, neither investors nor industrialists are scientific recording instruments responding promptly and exactly to a stimulus. They are liable to errors of expectation ; having planned an increased output, not all of them will be daunted by a

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depression that may not be of long duration. Secondly, the falling off of demand may be concealed ; for though we are attempting here to isolate the effects of investment from changes due to other factors, they cannot so easily be isolated in reality ; and if a growth in the habit of saving is accompanied by an expansion of credit the price level, instead of falling, may merely fail to rise, or may rise less than it otherwise would.

But, finally, the presumed discouragement does at times take place. When a growth of savings is unaccompanied by an expansion of credit, or synchronises with a contraction of credit, the consequent fall in prices is sufficient to frustrate the intention to invest ; savings remain in the form of unspent balances, and a state of severe depression ensues. When this has lasted some time bankers point accusingly at the idle balances and the low bank rate and explain how perfectly willing they are to advance credit to sound borrowers. But by this time concerns that were once sound are unsound, and those still sound are unwilling to risk their solvency by turning borrowed money into products which nobody seems to require. That appears to have been the situation reached at the end of 1930. At that date there was undoubtedly an accumulation of money which people would neither spend on consumable goods nor invest ; but there had also been a prolonged restriction of credit ; and, while the growth of savings unquestionably accentuated the depression, there can be no doubt that the conditions produced by the credit restriction were themselves, at least in part, the cause of that striking curtailment of private expenditure.

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The investments we have so far considered have been confined to a self-contained community. But money may be invested abroad. True, the borrowing countries spend the money on goods, and it used to be popularly supposed that in lending abroad we were to that extent stimulating our export trade, thus compensating for the reduced sales at home which the savings had involved. This happened to be near enough to the truth during most of the nineteenth century. Our investing classes placed their balances at the disposal of young and developing countries, which used them to buy from us the manufactured goods that we could supply more cheaply than anyone else.

Nevertheless a borrowing country is not obliged to spend its borrowings in the country that raises the loan. If British investors buy the securities of Canadian companies, balances are placed at the Canadians' disposal which, in the absence of agreements to the contrary, they may spend where they like. Should the machinery they want to buy with it be cheaper in the United States than here, there they will buy it, and the balances must be transferred to the United States. It may happen at the same time that balances from abroad are also due to us, owing to our exports exceeding our imports. If this favourable trade balance corresponds in amount with the capital exported the equilibrium of the exchanges will not be disturbed, and our manufacturers and commercial houses will have made up by foreign sales for those they lost through the investors' reduced expenditure at home. That is what is meant when economists say

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that the amount of our export surplus is the measure of what we can lend abroad. Thus, where we used to say, "Let us lend abroad, and our exports will thrive," we now say rather "*If* our exports are thriving sufficiently we can lend abroad."

But the individual investor is not governed by the balance of trade. If foreign securities offer a high yield with no more risk than he is ready to face he will buy them; and if the outflow of money exceeds the inflow from foreign purchases, home industries will suffer through diminished demand and the exchanges will move against us. For investments abroad, it must be remembered, are invisible imports. The revenue derived from them is, of course, an advantage to the investing country; remittances flow towards it from the foreign borrower. But making the investment involves remittances outwards, just as though the money were spent on buying foreign goods, and, other things being equal, will turn the exchanges against the lending country. But an adverse exchange may affect us all. If a gold standard has to be maintained the result will be a curtailment of credit and consequent depression, and without a gold standard our money will depreciate and our imports cost us more. A suffering generation can derive little comfort from the knowledge that a small return will be reaped year after year by posterity.

What, then, should be our attitude towards thrift, concerning which contradictory advice was proffered recently by bankers and economists? Many regard it as a private virtue, others as a necessity imposed upon individuals by defective social arrangements: but

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what is its value to society? Writing on this theme,¹ Lord Riddell invited discussion on the following two cases :

"A and B are two brothers, aged respectively twenty-seven and twenty-eight, both married, with two children, both possessing an income of £600 per annum. A determines to make moderate savings. He buys his house through a building society, and from time to time makes other investments, with the result that when he reaches sixty he is in possession of an income of, say, £3 per week and his house. B, on the other hand, decides against saving. He buys a motor-car, or a sequence of cars; he uses his car freely and enjoys himself in other directions, with the result that at the age of sixty he has nothing. It may be difficult to prove that the thrifty A has provided more employment for his fellow-countrymen than the spendthrift B. But it is certain that B's money has been spent on perishable items, and that if his example were widely followed the country would be in a sorry plight. The material strength of a community consists of its more or less permanent assets, plus the skill and character of its people—its docks, its railways, its factories, its plant, its buildings, etc. etc."

Perhaps it will be a useful exercise to see what lessons relating to our problem can be learned from these examples.

Bearing in mind that what we are concerned with here are fluctuations in productive activity, we may observe first that there is no essential difference between A's house and B's car; both are consumers' goods as

¹ In *John o' London's Weekly*, for February 21, 1931.

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opposed to instrumental. A house, it is true, is among the least consumable of goods ; its owner is unlikely to "consume" it all in his lifetime ; this, however, does not remove it from the category of consumers' goods into that of those which add to the nation's productivity. The mediation of the building society makes no difference either, except to A, who is able to occupy his house sooner. It is bought, immediately, out of the savings of other depositors and shareholders who do not require a house themselves ; many people abstain from enjoying other goods for a short time instead of A alone for a long time. By buying a house A enables a builder to build another house, distributing wages in doing so ; by buying a car B similarly enables a manufacturer to make another car. A house may indeed be regarded as one of those permanent assets in which, as Lord Riddell says, "the material strength of a community consists." But B also presumably lives in a house : he will pay rent to a landlord permanently instead of instalments to a building society temporarily ; houses would not necessarily be fewer because every occupier rented one instead of buying it. Social advantages of real weight may undoubtedly arise from the ownership by a country's citizens of the houses they live in ; these advantages, however, have little to do with the economic repercussions of thrift.

For those repercussions we must look at that part of A's income which he invests ; and we shall probably have to watch it at one or two removes from A before anything significant happens. For a man in A's position is extremely unlikely to invest in new industrial issues. He may buy an endowment assurance

policy and eventually an annuity, and the effect we are seeking would depend upon what the insurance company did with his premiums. Or he may buy gilt-edged securities from some private holder, who might use the money in various ways. Sooner or later, however, we may suppose that someone acquires his money to invest it in productive industry.

The result is an increase in the nation's productivity, in the course of achieving which A's money is distributed in wages and salaries and so forth, whose recipients are thus able to buy goods from which A abstained. But although the goods accumulating while A saved money, or their equivalents, have now been sold, no action of A's has created a demand for more goods or the money with which to buy them. We have, therefore, an increased productive capacity which there is no inducement to employ, or an increased output which no one can purchase. In the absence of creations of credit to stimulate still more production, the result must sooner or later be an enforced reduction in prices, which, though agreeable enough to consumers as such, invariably in the present social order entails loss to producers.

Brother B meanwhile has been popular in shops and showrooms as a steady spender. His income he regards as the means of obtaining his share of the national production; that is what it was given to him for. By using it to that end he enables industry to carry on at its accustomed gait without creating for it problems of distribution; so far as B is concerned industry knows where it stands; he encourages it to use its permanent assets for their proper purpose;

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let A set what store he likes on these permanent assets and the value to the nation of accumulating them ; in B's view their business is to deliver the goods.

"But if B's example were widely followed," says Lord Riddell, "the country would be in a sorry plight." It is true that B, while keeping our factories busy, does nothing directly to increase their size or number ; but, assuming that such increases are always and necessarily desirable, does it follow that they cannot be attained while all consumers behave like B? No, it does not follow ; that is, it does not follow if the behaviour attributed to B is merely that of individual consumers with their personal incomes. For the companies which so readily dispose of their wares to a public composed mainly of B's may themselves regard expansion as desirable, and refrain from distributing all the profits they earn. The re-investment of profits is nowadays a common practice with successful companies ; and it is not certain that spenders like B would be the first to criticise this policy. In so far as the B's are shareholders they may well argue that since, as co-partners in an industry, they thus maintain and increase its strength, they are entitled as consumers to spend freely the income they allow themselves. If, however, this is ruled out because it shows them not to be the complete spend-thrifts the hypothesis assumes, must we then reconcile ourselves to an industrial equipment incapable of expansion ?

Again the answer is no ; so long as expansion is desired and the labour and materials necessary to accomplish it are present, expansion may be financed

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by bank credit. True, an inflation of credit, as things are, invariably induces a painful reaction ; but investment, as we have seen, also produces difficult complications. Again, an issue of bank credit imposes a levy on the community as a whole by raising prices ; but any industrial expansion means temporary denial of some sort by somebody ; we do not pretend that capital development can occur without that ; for the present purpose we merely have to show that this denial need not take the form of monetary savings by self-selected individuals.

The fact that the question implicit in Lord Riddell's examples presents itself as a dilemma points plainly to a flaw in our economic system. " Is private thrift a public benefit ? " is the question. In a reasonable society the answer would not be hard to find ; if anybody chooses to consume less than he is entitled to, we should say, so much the better for the rest. Even if his denial is merely a postponement, no one else should suffer ; we have merely to arrange that no more perishable goods are produced than are immediately required, and that should not be difficult in a large community.

From time to time society would need to put the question to itself in a more particular form. For some years now, its leaders may be imagined as saying, our industries have steadily expanded, and new inventions have further enlarged their productiveness. Shall we for a while content ourselves with the ample output they can easily maintain, and enjoy more leisure, or shall we continue to expand them ? On this question citizens might vote differently according to whether

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they desired leisure or goods the more ; but it is a plain question, not a dilemma.

As things are, however, the problem takes this form : We desire our industries to expand and new ones to develop. To do that they must have money with which to pay for additional labour. If we persuade people to save their money instead of spending it the shopkeepers are hit, and through them manufacturers, and through them labour, which loses its employment. But if these alarming symptoms are somehow prevented, or fail to discourage investors and entrepreneurs, then the money is eventually distributed and spent. Its amount, however, is no greater than it was, and when the expanded industries market their increased output this can only be sold if prices are reduced. Unfortunately, we have not learned how to reduce prices without inflicting hardship on somebody ; the process invariably leads to the discouragement of enterprise and to unemployment.

If, on the other hand, the money is obtained by bank credit, there is no preliminary saving ; new labour is engaged at once and the money begins to circulate. Since the quantity of goods has not magically increased because the factories intend to increase it later on, and since the quantity of money manifestly has increased, pressure of demand will send prices up. Once more all the money available will tend to be absorbed by current goods, and none is left to buy the increased output when it materialises, unless the bank continues to issue money. It will continue for a considerable time ; it will re-issue credit again and

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again to finance still further production, and since one credit tends to necessitate another, and since a higher level of prices calls for more credit to finance a given output, the process normally involves a continuous expansion of credit and rise in prices. But for reasons which most people take for granted a credit inflation cannot go on for ever—and when it ceases goods are left high and dry, incapable of being sold at the price they cost to make. So what are we to do?

The nineteenth-century solution was to sell the surplus abroad and make foreign nations our debtors. That solution is no longer available. Our former foreign customers have industrialised themselves and are now facing the same problem. Some of them have intensified it by leading the way in rationalisation, which is a process of improving factory organisation, and of enlarging the number and perfecting the efficiency of industrial instruments, in order that the greatest possible output can be obtained with the smallest possible use of labour. To urge any one nation to go farther than the rest in this process and so undersell them is a dangerous doctrine, besides being ultimately no remedy.

The problem with which society is faced is clearly not a problem of production but one of distribution; and no amount of thrift will solve it.

CHAPTER X

WHAT IS CREDIT ?

WHEN we say that a man's credit is good we mean that he can be trusted to discharge his financial obligations. His creditors will not be concerned for the safety of their loans, because they believe he can pay his debts. Credit, therefore, appears to be a quality or power that a man possesses. It may also be possessed by a company or a nation.

But to say that a man's credit is good need not imply that he has any creditors at all ; it may imply, instead, that creditors will be forthcoming if he requires them. What they give him is also called credit, which thus appears to be something obtainable by a man who already has it, and the more he has of it in the first sense the more he can obtain in the second. Is this a confusion of terms that ought to be differentiated, or are they essentially the same thing ?

Credits are the converse of debts : a credit, of course, implies a debt. In modern usage both are expressed in money, and debts are due to be paid in money, though not necessarily incurred in the form of monetary receipts by the debtor. A credit is essentially a transference of goods and services to the debtor in

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exchange for a claim on goods and services maturing later, or, shortly, a borrowed claim on goods. But since the goods or services thus acquired by the debtor are intended to be consumed, either instrumentally or otherwise, he must obtain control of other goods or services in order to repay his debt, and it is his presumed ability to obtain such control that constitutes his credit in the sense in which we regard it as a quality inherent in a person or corporation or community. This form of credit may be defined as the ability and willingness to deliver goods and services.

It is called by Major Douglas "real credit," and he defines it as "a correct estimate of the rate, or dynamic capacity, at which a community can deliver goods and services as demanded." It will be noted that real credit is by this definition regarded as an attribute of the community. This is a fundamental truth; it is by no means a newly discovered truth, but it is one whose significance is greater to-day than ever it was. All individual credit in the sense in which it has any economic importance nowadays is based upon that of society, for the ability to produce, except on a most meagre and hazardous scale, presupposes a condition of social order that is derived from the virtues of citizens and their willingness to co-operate. Without these the credit of an individual would be of little account. Further, production on a modern scale is only rendered possible by that vast store of instruments, inventions and knowledge which no man living, no group of men, not even the whole generation of men, can claim to have created. One generation adds a little to that which it holds by

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inheritance, and in this rich inheritance every citizen has a share.

A nation's real credit—its ability to deliver goods and services—comprises all the goods in existence within its territory and any it may own in other territories, plus its ability to add to their quantity. A financial credit is a claim upon real credit. All financial credits, with one enormous exception, are claims on real credit transferred to the borrower *from the creditor*. It is obvious that if a merchant tips coals into my cellar without requiring payment till next month, he forgoes for a time the claim on real credit which my money would give him. Similarly, if I borrow a five-pound note from a friend he forgoes the right to the goods and services which the note might buy, and I enjoy that right instead.

If, however, I borrow a thousand pounds from a bank to use in my business, the bank does not forgo any goods or services; neither do its customers forgo anything, for not one of them is prevented by my transaction from drawing on his account to buy what he pleases. Yet the loan gives me the right to goods and services, and that right I, as an enterprising industrialist, promptly exercise. If the goods are not transferred to me from the banker, from whom are they transferred ?

It should be clear from what has already been said in this book that they are transferred from the community as a whole. Whatever goods I buy with my borrowed money, or whatever goods are bought with it by the workmen whose wages I use it to pay, are subtracted from the total quantity of goods purchasable.

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The banker has created additional claims on the quantity of goods in existence ; those goods will be divided among a larger number of money-units ; each money-unit will therefore buy a smaller quantity of goods than before ; prices go up ; everybody else's money is depreciated by the banker's loan to me.

Because money constitutes a demand upon a community's store of wealth, none but the State can claim the right to issue it. Because bank credit is also a demand upon the community's wealth, its issue by private parties would never have been tolerated had it been consciously adopted as an additional form of money and its nature clearly recognised. Bank credit is a convenient device ; its use might be extended rather than curtailed ; its administration might continue to be conducted by the institutions in charge of it now ; but because it is a levy on the public, if for no other reason, it should be brought under public control.

There are other grounds for demanding this. An industry or service may be stimulated by financial credit or allowed to decline for want of it ; but in choosing which shall decline and which flourish a group of private banks may not always be actuated by public interests. Public weal may demand the assistance by credit of a service that does not promise the sure and speedy financial return that banks prefer ; and public weal may not in the least be furthered by the enterprises into which bank credit goes instead. Banks require a financial return ; by which is meant not the interest they charge on their loan (that is a matter of little moment) but the loan

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itself, which must come back in financial form to be cancelled. So long as a borrower uses bank money, which is strictly public money, in such a manner as to be able to repay it, the bank is not in the least concerned whether its use has been social or anti-social in character. A borrowed financial credit need not be employed to add a pennyworth to the nation's resources ; it may enable a speculator to buy securities or commodities which he expects to rise in price ; it may facilitate the merging of concerns with the object of restricting instead of enlarging their combined output.

Finally, apart from specific applications and mis-applications, bank credit has become so vital an element in our industry and commerce that the whole organism would wither were it withdrawn. Yet periodically it is withdrawn ; not indeed wholly—that would cause the complete collapse of society—but sufficiently to spread distress throughout the land. Banking policy is not a matter that concerns merely the banks and their customers ; it concerns the whole community, and by the community's political organs, therefore, it should be controlled.

The functions and policy of a public banking system would differ somewhat from those of a private one. The functions of the banks to-day are (1) to take charge of the money of individuals and corporations and to facilitate payments between them ; (2) to create credit-money for the use of those who can most surely and speedily return it. The power to perform the second of these functions is derived from the first. The extent to which the banks can create credit is

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limited by (a) the need to hold a certain proportion of cash, and (b) the policy of not allowing so much money to circulate that the amount spent on foreign-trade goods turns the exchanges against the country and causes exports of gold.

A public banking system would (1) provide the same facilities for depositors as a private one, and would (2) issue financial credit to such industries and services as legitimately required it, so long as the real credit necessary for its use were present. A legitimate requirement for credit is an ability to use it for some object publicly desirable. If, for example, houses are needed, and builders and bricks are available to build them, they should not remain unbuilt for want of money. If a cotton industry is dying for lack of modern plant, and at the same time an engineering industry is languishing for want of orders, credit should be issued to set the engineers at work upon textile machinery. And if these issues of credit call for more cash, cash should be circulated, notes should be printed; if this were done to-day the newly employed workers would find no shortage of goods on which to spend them. When every man is employed and stores are cleared out as fast as they can be replenished, then we may decide that as much money has been issued as the circumstances warrant. This is not a contingency that often arises, as any shop-keeper, any manufacturer, and any Labour Exchange manager will tell us.

A public banking system, then, while it would make no loans for purely financial ends, would issue credit for publicly desirable ends all the more freely because

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it would be no longer limited by a fixed cash reserve or pre-occupied with the level of prices. At present their concern for the equilibrium of the exchanges compels the banks to pay some attention to the level of home prices. A fluctuating price level entails certain evils, as we have seen ; and some of our leading economists think that bank policy should be directed far more deliberately and scientifically than it is towards preventing these fluctuations. For the stability at which the economists aim is not always what the bankers secure by their efforts to stabilise exchanges. Stable exchanges do not necessarily require a stable price level ; they require as a rule that the internal price level shall move in the same direction as that of other countries ; in particular, that the home price level shall not remain high when foreign prices fall. Since this country has, in recent years, stood in greater fear of losing gold than of importing unwanted quantities of it, banking policy has been directed towards keeping home prices low. But when prices have to be brought down or kept down by credit restriction very few people are benefited, and many suffer.

Now we believe that prices must be controlled, and in this we are in good company ; but most of this good company is satisfied with an indirect control exercised through the manipulation of credit. Prices, it is argued, are the result of certain determinants of which the most directly controllable is the volume of money. By regulating the volume of money, which in a modern State means the volume of credit, we can control prices. Let us therefore loosen the bonds which at

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present bind credit too rigidly to an inelastic quantity like gold, and use the flexibility thus obtained to correct any undesired movement in the price level. Let us issue the quantity of money necessary to maintain prices as a whole at the level we prefer, runs the argument, and we may let producers continue to scramble for this money among themselves.

We do not deny that much good may be accomplished by this reform ; but compared with what is possible the mere stabilisation of prices by the action of bankers is clumsy and inadequate. Exactly what sort of stabilisation, within the existing social order, would be most beneficial to society is not an easy matter to settle, and the searching inquiry into the trade cycle made by Mr. Dennis Robertson in his " Banking Policy and the Price Level " leads one to conclude that, were the object an agreed one, finding the proper measures to take for securing it, and choosing the right time, would be a complex problem for bankers, quite apart from a possible conflict with other interests they have to serve.

The regulation of prices, however, is not a banking function. Yet regulated they must be ; I do not see how that necessity can possibly be escaped, though some will wish to escape it. For there are still traders and producers and journalists and even economists whose thoughts appear to move along lines laid down in the nineteenth century, and beneath whose arguments lies the assumption that the country's industry and commerce are still carried on by a vast number of small and independent capitalists whose competition between each other is so keen and incessant that

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prices can never long be unjust to the consumer. Whether this state of affairs was ever entirely desirable or not, it is ceasing to exist. The position of the small capitalist is becoming an impossible one ; he goes out of business, or he is bought up, or he merges with a group. And every day prices are being controlled before our eyes by associations of tradesmen and combinations of producers.

In these matters, it appears to be believed, the Government can do no right and nobody else can do any wrong. So long as the Government does not meddle, prices are presumed to find a "natural" level which, whether a comfortable one for consumers or not, cannot safely be altered, because to alter it would violate a sacred and inexorable law called the law of supply and demand. Now this law, as applied by many of the advocates of non-interference, is really a great piece of humbug ; and even its widest generalisation, the famous Quantity Theory, though it can be made to look as inevitable as gravitation, bends before a steadfast gaze. Certainly we can see it in operation ; when there is more money, other things being equal, prices go up. But they do not go up unless somebody puts them up ; the action is no more inevitable than that of the burglar who makes off with your silver because you have failed to lock it up, and should be no more condoned if its consequences are socially bad.

Does there seem here an inconsistency with what has been said in earlier pages ? More than once we have shown how an increase in credit causes prices to rise and how high prices enforce a credit contraction,

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as though these processes were automatic, given the initial expansion of credit and the presence of the gold standard. Stated thus, the banker seems to be the only conscious agent, and responsible for what takes place. Well, he must bear a large share of the responsibility, because the initiative lies with him and he knows exactly what consequences will follow from his actions; and if he knows also that other people's actions contribute to those consequences he can say so. Bankers do now and then express themselves upon economic affairs, but one does not hear them denounce as socially evil a distributive system that consists in letting anyone who has anything to sell get the most he can for it. Bankers are in a better position than most people to see the peculiar results of that system, and by remaining silent they add to their responsibility. It is a system which, operating in conjunction with a flow of credit capable of fluctuation, is almost bound to bring a period of prosperity to an end sooner or later. How this effect is produced may already be clear to the reader; if not, I hope it will soon become so. Meantime it must be plainly declared that the action of bankers is not of itself the sole and inevitable cause of the economic evils with which we are concerned. For this reason the assumption by the State of the control of credit is not by itself a remedy; to this must be added the regulation of prices, and we must now try to establish the principles upon which a sound system of price regulation may be based.

CHAPTER XI

THE PRINCIPLES OF PRICE

MONEY, as we have seen, performs a dual task ; it stimulates the production of goods and services, and distributes them when produced. This looks on the surface a reasonable arrangement, since it ensures that nothing is consumed unless something is produced in its place, thus securing continuity in the supply of goods. Yet it is easily seen that the essential function of money is distribution, pure and simple ; for while we cannot conceive of money being used at all where no consumption took place, or where money conferred no right to consume, we can readily imagine it being found a convenient device in a community so circumstanced that no productive effort was required, or, if required, was provided without monetary reward.

Suppose a thousand people to be living on one of those islands that economists find useful, and suppose that enough fruit of various sorts ripens day by day to maintain them. Suppose also that they require nothing else. If these people have been used to money in more civilised lands they may adopt it here as a means of distributing the island's produce among themselves, especially if a perfectly equal distribution

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were regarded as less equitable than one based upon individual needs, merits, or some other variant. The fruit, herbs, nuts, and so on might be collected by volunteers each morning, and brought to a central store. Each man might there be paid his daily income, which need bear no relation to the amount of work he has done. How smoothly this plan might work would depend upon the agreeableness or otherwise of such labour as was necessary, and still more upon the willingness of every inhabitant to co-operate.

One or two assumptions may be made concerning the money used in this community. (1) It need have no intrinsic worth; its nominal value would be determined by the fiat of the man or committee elected to issue it. (2) The issuing authority could vary the amount in circulation at no appreciable cost to itself. A £10 or £100 note can, of course, be destroyed by a bank and a new one issued at the mere cost of paper and printing, just as a bank loan can be granted or cancelled at the cost of writing a few lines in one or two books. (3) It would represent general purchasing power. Money would be issued in the same units as those in which the prices of all commodities were expressed; a unit of money that could buy a bunch of bananas must be valid to buy anything else of the same price; otherwise what we have is not a system of money but a system of rationing. In short, the money used by these islanders would resemble that of any modern community, save that it would bear no relationship to gold.

But money would be recognised by the islanders as part of the mechanism for distributing goods;

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money and prices perform that function together. This being so, it would be obvious that prices must not be higher than the money made available to pay them. Whatever variations might exist in the prices of different fruits and in the incomes of different individuals, total prices must not be higher than total incomes. If inadvertently they were, prices would have to be revised downwards or incomes upwards. Our islanders would arrange this deliberately. In real life it is brought about by force of circumstances clumsily, painfully, and wastefully.

Let us now permit these people to drop their strange plan of paying pensions or annuities to everybody, and suppose them to conduct themselves like civilised human beings; let the island resemble a modern community, apart from its size and the simplicity of its commodities. Production is controlled by a few competing entrepreneurs, who make what profit they can, and the rest of the community receives wages for work done. The work is of two kinds: (1) tending the plantations and gathering the fruit; and (2) making knives, fibre-ladders, and other instruments required on the plantations. The entrepreneurs who organise these two kinds of work we shall call the Fruiterers and the Toolmakers respectively.

After a period of comparative stability, during which most of the producers find trade reasonably profitable and a fair proportion of the workers are employed, a change may take place. The community is seen to become more active. The unemployed are put to work; new plantations are sown, the older ones are cultivated with greater energy, more tools are

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made. For a time the effort seems to produce little reward in the shape of the fruit required by all consumers ; but eventually fruit is gathered in far greater abundance than ever before, yet at a rate which the island's newly developed resources are able to maintain permanently.

At this point, to the astonishment of any intelligent Martian who may happen to be watching, the supply of goods that these islanders have worked so hard to make possible begins to accumulate in warehouses, and their production to fall off, not because people do not want them—there are by this time many in need—and not because those in charge of the warehouses like to keep goods locked up therein unsold. Why, then ?

We may suppose that the activity was induced by the discovery of some new field for enterprise. A plant is found which by cultivation can be made to yield a new and delectable fruit. Money is issued to exploit the discovery, and is spent as fast as it is issued upon fruit from the old plantations, the price of which promptly goes up, since its quantity has not yet increased. The growing demand for tools sends the price of these up too. Next, the high price that fruit is now fetching causes other entrepreneurs to turn their attention to certain rather inaccessible and low-yielding plants which nobody hitherto has thought it worth while to harvest. At the prices now ruling it becomes worth while, and a little more fruit does at last reach the market. This will steady prices a little, but obviously the effect will be slight, for more labour than normal must have been employed for a given

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yield of fruit (that is why its production was unprofitable before) and this labour must have been paid for, thus further diluting purchasing power. The higher prices offered for tools may also stimulate enterprises which can now just make a marginal profit.

To meet the rising cost of living the workers demand higher wages, and at some stage their demands will prove irresistible. Prices as a whole, for labour and for goods, have now reached a higher level.

But when the new plantations begin to yield, prices cease to soar, and when the yield is greater still we must assume, in order to account for what the Martian saw, that prices drop. We are obliged to assume this, for what the Martian saw was a decline in industrial activity and a failure to distribute goods, and these are symptoms of a relative falling off in demand, which inevitably leads to lower prices. It is this falling off in demand that has to be accounted for, since it may occur quite apart from any increase in supply. Two explanations are possible: either the islanders are hoarding money, or the amount in circulation has been reduced.

We saw in Chapter VI how such a situation could arise, and we may in brief fashion apply the lesson we there learned to this island. Let us again suppose that when the cycle began £2,000 was in circulation. This is the cost of a week's supply of fruit. It is withdrawn from the consumers by the Fruiterers, though some of the costs were incurred at an earlier date by the Toolmakers who, as they cannot recover directly from the public, receive a portion of the

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Fruiterers' weekly takings in return for tools. The £2,000 includes profits, which are distributed each week by the various companies to their shareholders, and spent upon fruit for their own consumption.

The money in circulation is now increased by issues from the banks to develop the new plantations, and when we resume our observations £3,000 is circulating, this figure having been reached by small increments made from time to time. We said of the £2,000 that it represented the cost of production, including profits, of the fruit ready for sale each week. But we cannot say that the whole of the £3,000 now in being represents the present cost of producing a week's fruit, for some of it is the cost of preparing new estates. Still, the cost of a week's fruit will be more than £2,000, for wages have gone up and more workers are employed in producing fruit and tools for immediate use. Let us suppose that the total cost now of a week's fruit, including profits proportionate to the higher level of prices, is £2,600, the remaining £400 being spent on development that is not yet producing anything against which it can be charged.

It is clear that so long as £3,000 continues to be issued and spent the Fruiterers can sell their produce and more than recover their costs. If expenditure is reduced by more than £400, either by saving on the part of consumers or by a withdrawal of credit, or by a combination of these two factors, then the week's produce cannot all be sold, or must be sold below cost. And it does not follow from this that expenditure must be reduced by as much as £400 before it affects production. This would follow if the entrepreneurs com-

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prised one non-competitive organisation, but they do not ; some of them are less efficient than others, and their margin of profit is so small that a slight reduction in selling prices wipes it out. These cease to produce, or produce only with the more efficient parts of their resources. They discharge workers and reduce their orders for tools and raw materials, whose providers must in turn discharge workers and reduce orders.

At this stage employers will proclaim that the remedy for the declension now in progress is lower wages. This would certainly assist any one industrialist if applied solely to the workers he employed, but would be of little use if applied generally. Meanwhile the more efficient producers are able to carry on, and may do so even when the community's expenditure falls below £2,600. For just as the production costs of some concerns are above the average, those of other concerns are below it. These are able to meet the falling prices without loss, though with reduced profits, and the flow of goods continues, further embarrassing the less efficient. Unemployment grows and bankruptcies begin.

But is there nothing else in the described course of the island's history that is not as it should be? Undoubtedly there is. Will the reader be patient enough to return once more to our starting point, where £2,000 was distributed each week in wages, salaries, and dividends? We did not separate the profits from the other charges, but we assumed reasonable profits to be there. We may continue with this assumption so far as the original £2,000 is concerned ;

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the profit represents a living income for the shareholders, and they spend it on fruit.

Now suppose that the island's development begins with the issue in the first week of £200 for spade work on virgin soil. Ignoring for the sake of simplicity the fact that credit will also be spent on new tools, which will have its effect on the Toolmakers, let us confine our attention to the £200 mentioned and suppose it to be all spent on wages to newly employed workers. This sum must be added to the £2,000 already received weekly by workers and shareholders of the older concerns. Therefore the consumers' income has risen from £2,000 to £2,200—and the Fruiterers obtain 10 per cent. more for a week's fruit than they did before. This is shown diagrammatically, though with different sums, in Fig. 3, page 68, where Household Goods, Ltd., is similarly seen about to enjoy an extra profit. What is the justification for these profits?

There is none. They are extorted from the public by those traders who first become aware that there is more money about and do not scruple to raise prices. They have done nothing to earn any more; it is not the reward of enterprise on their part; the enterprise is somebody else's. Because someone is trying to grow new trees and spending money thereon the fruiterers charge more for their fruit; because a steel-smelter is enlarging his works bootmakers charge more for their boots. The rise will not be instantaneous, and it may never be proportionate to the increased volume of money, but a rise there will be. This is what invariably happens during a boom.

Not without justice might we say later on, when

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traders cannot sell their goods because their customers have insufficient money to pay what they cost, let them bear the loss out of those excessive profits by exacting which they first raised prices. But between the two events months or years have passed, and it would be impossible to discover where these profits have gone. Some have been spent, some invested, some bequeathed. There is no means of ensuring that the original beneficiaries should now be the losers.

It is important to note that when our community has reached the point where £3,000 circulates instead of the £2,000 that formerly sufficed, especially if the figure has remained stable at £3,000 for some time, nobody may be any longer reaping more profit than the unspecified proportion that we have agreed to regard as legitimate. Wages, salaries, and all other charges have by this time risen, and the division of the national income may be the same as it was before the change started. Consequently when a slump occurs through a contraction of available money the entrepreneurs will not appear to be the responsible parties. They are as badly hit as anybody else, they will proclaim, and evidence will be there to support them. For it is not their exactions at this period that cause the trouble, but those which they made during the period of expansion.

This licence to raise prices simply because the money is there to pay them seems to me to be crucial. For not only is it indefensible on grounds of social justice; by encouraging imports and thus expelling gold it necessitates that eventual contraction of credit whose

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consequences are painful to nearly everybody, but not invariably most painful to those whose action caused them. This does not exonerate the banks or the gold standard they have imposed on us ; it does, however, show that the stability of that standard is made harder to maintain than it need be by the cupidity of profiteers.

It seems plain, then, that fortuitous profits made possible by an expansion of credit must be prevented by the regulation of prices. The new money will remain in the hands of the consumers. They will be unable for the time being to spend it all ; that, however, is a lesser hardship than to lose it in paying higher prices for the goods they do buy. Eventually they will spend it on the goods whose production is being fostered by this very money. Meantime credit to finance short-period efforts to increase the flow of consumable goods will be issued all the more readily by bankers because no rise in the price level threatens to create an adverse balance of trade.

The possible objection that the possession of money which cannot be spent may lead to a competitive rush for goods, compelling tradesmen to ration their customers, has little weight. Panic demands for goods are not unknown ; they arise, however, not from a shortage of goods compared with money—except in extreme cases of inflation—but from a shortage, compared with need ; and the panic grows as prices rise. Moreover, panic demands are concerned mainly with food ; so long as this is abundant there is no panic. The plan here proposed involves no absolute shortage of goods of any kind, and rising prices are

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ruled out. Certainly demand will be stimulated, though not with embarrassing suddenness.

The plan could be put into operation most smoothly at the trough of a depression. Prices would be fixed for the time being at the level they had then reached, not because this necessarily represented a fair price for all commodities, but because it is the only practicable starting-point. A permanent Economic Council would be appointed, with the regulation of prices as one of its principal functions. For a long time it would confine its attention to essential foods, fuel, clothing, transport, rent, and the most important household requisites ; probably it would never extend its range beyond these categories.

Credit would now be issued to those industries that most needed rehabilitation and development. Our textile industry might be re-equipped, electrical development might proceed more rapidly, and a number of projects might be started without in the least overtaxing our productive capacity. At once the unemployed would begin to be absorbed. The demand for foodstuffs would slightly rise ; for clothing the rise might be steeper. Accumulated stocks would bear the first impact, and probably they would prove adequate till new supplies came forward ; people do not greatly increase their consumption of necessities when they become better off. Some enforced waiting for luxury goods would undoubtedly be experienced, as there was for motor cars in 1919 and 1920, and even for goods hardly describable as luxuries nowadays.

For an indefinite time the volume of money circulating will steadily increase, accompanied by an

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increased output of both consumable goods and instrumental. A period of industrial activity will have begun similar to that attending any expansion of credit, but unaccompanied by rising prices. So long as development continues, more money will circulate than is required to purchase the current output of consumable goods, with the consequence that these goods are likely to be in steady demand; in fact for a time demand is likely to be insistent, and producers will be encouraged to increase their output. If there comes a point where no further improvements in method or machines enable output to be increased without a longer working day, and if producers are unwilling to work a longer day, then consumers must regard the standard of living then attained as for the present the highest possible. In so far as consumers and producers are the same people they will be content with this standard, for their disinclination as producers to work harder indicates that they value leisure more highly than increased goods.

A period of stability may ensue during which production and consumption will be equal, wastage of plant being replaced, but no additions being made to fixed capital until some new invention or discovery makes development again desirable. This stable condition, though it may never be attained, is that towards which society's economic forces may be said to be always striving. So long as it lasts the volume of money circulating will not change, and it will be exactly sufficient to purchase the current output of consumable goods.

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No doubt the reader will already have realised that prices, under this plan, are exactly equal to costs of production, if costs are understood to include what for the moment we must call normal and legitimate profits. We cannot defer for ever a separate treatment of these "legitimate profits," but for a little while longer we must lump them with the receipts of the producers as a whole and regard them as equivalent to labour charges of some kind. The sum of these charges incurred in producing any commodity is the price at which that commodity is sold. And this is true not only during the condition of stability in which expansion is assumed to have ceased; it is true also during the expansion. For prices are not allowed to absorb the costs of expansion. Those costs were of course earned by the producers, but remained in their pockets, for as consumers they were able to buy all the goods that had reached the consumable stage without them. They paid all the costs of what they consumed, including the machinery and so forth "consumed" by depreciation in producing the commodities that actually reached them; but they did not pay for the additional productive instruments created during the same period. It is right that they should not pay for these, for they have not consumed them; it is right that they should have the money they cost, for they produced them. What each thus saves represents his share in the nation's increased capital.

This retention by the consumers as a whole of money spent on expansion is, with the consequences it entails, the feature that distinguishes the economic

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order I am describing from that which exists. Under present conditions that money would not be so retained; it would be absorbed by rising prices. These would encourage imports, and it only needs a money system anchored to gold to enforce a contraction of credit and a reaction from the boom. The ability to expand without sowing the seeds of any such reaction, while it does not imply that a stable and static condition will ever be reached, would permit such a condition to be maintained if it were reached.

But stability is not merely a question of equilibrium between money and prices; it can be disturbed, as we have seen, by changes in the uses to which money is put. Demand for consumers' goods as a whole may fall off, or variations may occur between the demand for one group of commodities and that for another. We must therefore inquire how such changes may be dealt with in order to avoid the evils which they cause at present.

Suppose that the bootmakers by improving their methods increase the production of boots. The total costs of production are no lower, but the cost per pair of boots is; therefore the selling price per pair may be reduced. Where formerly 1,000 pairs were made at a total cost of £1,000, selling at £1 a pair, now 1,250 are turned out at the same total cost, and may be sold at 16s. per pair. But the demand for boots, we will suppose, is not very elastic; few people are induced to buy more boots by the lower prices, and the population has not grown sufficiently to absorb the enlarged output. For simplicity let us assume that no increased demand at all has taken place;

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1,000 pairs of boots have been sold at 16s. and the bootmakers recover £200 less than their costs. Since they are financed by credit they owe this sum to the banks. Against it they have a stock of boots which they will sell sooner or later, and in practice the debt need not be so great, for reductions in price might be made more gradually. But to maintain the enlarged output, seen to be premature, would be useless and wasteful; 1,000 pairs of boots per day or week or whatever it may be are enough for the present. Since they can be made in less time than they formerly could the bootmakers' working day may be greatly reduced, and once more 1,000 pairs of boots sell for £1,000.

Now this is pleasant for the bootmakers, and nobody is any worse off; but whether it is fair or not depends on whether the credit for the economies of effort that have been effected is due solely to the bootmakers themselves. We can hardly suppose that it is. This generation of bootmakers are the trustees of a productive organisation that the community has inherited. The improvements they contrive are modifications of a plant and technique that they did not themselves create. Often they will emanate from other industries. An invention of value to bootmakers may come from the brain of an engineer who has never made a boot in his life; a new material, or a method of improving an old one, may be discovered by a chemist having no connection with the industries that eventually use it; and the inventor and the chemist will have worked from prior knowledge derived from the common stock. Invariably we shall find it just that the

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advantages of industrial improvements should be shared in some measure by the public.

Since the public, in our example, does not want more boots, its share of advantage can only come in the form of lower prices for those it does want; a pair of boots should not be £1, giving the bootmakers all the advantage, or 16s., giving them none of it, but something between the two. Unfortunately, however, if anything less than £1,000 is paid for the 1,000 pairs of boots required, the bootmakers must either reduce their staff or their wages. That is what happens in similar circumstances to-day; and even under the new régime it may well be that reductions of staff are sometimes demanded. Other producers may be able to declare that a particular unit is over-producing not because its efficiency is above the average, but because it is over-staffed. Either a wrong estimate has been made of public requirements and recruitment for that unit has been too rapid, or a change in public habits has caused a diminution of demand.

The merits of such a plea would not be hard to ascertain; changes in demand and in the numbers employed would be known statistically, and a unit over-staffed might justly be expected to reduce its personnel. Not quite so obvious is the justice of requiring a similar reduction where the larger output is genuinely a consequence of increased efficiency. Let us see how it works.

The community requires 1,000 pairs of boots, which can now be made in four-fifths of the time they once took. The producers charged £1,000 formerly, and need now only charge £800. But such a charge would

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give all the advantage to the consumers, so let us suppose that £900 is the new price; the consumers get their boots for less than before, and the producers get more money for each hour's work. But obviously the producers get less money absolutely; it is because they work fewer hours that the rate per hour becomes higher. Only by reducing their numbers can those who remain earn the same money as they formerly did. If they dismiss one-tenth¹ of their staff the rest can retain their former earnings and slightly shorten their working day as well. If they dismiss nobody they can shorten their working day still more, but will receive less money; their working hours will be shortened by one-fifth and their money by one-tenth, and if they value an hour's leisure as highly as the money they formerly earned in an hour's work they are gainers. But whether they do value leisure enough to welcome this change will depend mainly on the standard of living that the new wage represents, for a man earning barely enough to support himself will not desire any decrease in wages no matter how much leisure accompanies it, and one who already earns far more than he needs may sacrifice a lot for leisure.

We cannot say precisely in which state a group of hypothetical bootmakers is to be found; but concerning the proposed reduction one important point may be noted; whatever its amount may be, it is

¹ For simplicity I continue to regard all costs as labour costs and all men's wages as equal, and ignore for the present the complications introduced by fixed interest charges and the fact that a lower output may not be proportionately as cheap as a higher one.

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less onerous in purchasing power than in money ; for the bootmakers are themselves consumers of boots, and in future will pay less for them ; and if the product is not really boots at all but something that bulks larger in a consumer's expenditure, then the offset to the reduction of income is all the greater. In order to complete our estimate of the net result to the bootmakers we must consider what other producers are doing.

Either the increased efficiency of the bootmakers synchronises with a similar advance by producers of other commodities, or it does not. If it does, then the prices of all goods will decrease and the bootmakers' reduced incomes will buy as much as the higher one did before, their increased leisure being pure gain. If it does not, and the bootmakers desire their income to remain at its former level, they must sacrifice some of their leisure by reducing their numbers. This course, in the given circumstances, is also seen to be socially desirable. For consumers, by paying less for their boots, have more money for other things. Though they do not require more boots we need not suppose that they are satiated ; there may be plenty of goods they do want. Perhaps they want wireless sets, or artificial silk goods, or perhaps some entirely new device has caught their fancy.

Whatever it may be, the producers of the desired commodity cannot at a moment's notice improve their machinery or methods sufficiently to satisfy the new demand. They must either work longer or increase their staff. But they presumably esteem leisure as highly as everybody else, and are as much entitled

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to it. The solution seems to lie in transferring the redundant bootmakers.

Now the perfect mobility of labour often seems desirable on economic grounds, but cannot be secured without tyranny. In fact, perfect mobility can hardly be secured at all, for you cannot convert a good bootmaker into a good electrician at a moment's notice, though this difficulty is growing smaller. But in a free and prosperous community, where the necessities of life at any rate were assured, it seems almost certain that men would be much more willing to pass from one occupation to another than they are when any such change is precarious and appears to have in it a large element of coercion. Moreover, the situation requiring it would not in practice develop suddenly. Industries would tend on the whole to keep pace with one another in their advances, and changes in demand and output would be foreseen, or realised before they had proceeded far. Voluntary transferences would in part correct disequilibrium: no one can tell how many people would eagerly follow a new calling if they could do so without risk. For the rest, the difficulty could generally be overcome by retarding or accelerating recruitment. The result would be a gradual shortening of the working day in all occupations, accompanied by earlier retirement, and a gradual reduction of prices as representing the consumer's share in productive progress.

Ways of meeting other fluctuations in demand are implied in what has been said. The demand for some commodity may diminish, not merely in the form of a failure to keep pace with productivity, but absolutely.

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Many people may cease to wear hats, and instead, say, of requiring 1,000 they require only 800. The price of a hat is £1; they cannot be expected to pay more per hat simply because they buy fewer. Perhaps some small increase in price may be justified on the ground that 800 hats cannot be produced so economically as 1,000; but the hatmakers cannot expect to receive the same sum for the smaller number as for the large. They will have more leisure, it is true; but if they want to maintain their earnings per man they must persuade some of their staff to attach themselves to industries whose products are in greater demand.

If consumption as a whole decreases—if, that is, the demand for all commodities falls away—then all producers will equally enjoy more leisure, and the question of transfer does not arise, though the question of earnings does. These, however, will be self-adjusting in so far as producers and consumers are the same people. For the falling off of demand will indicate that the producers themselves are reducing their consumption, and their smaller earnings will correspond exactly with their diminished desire to consume, and the reward for their abstinence will take the form of greater leisure.

But is it necessary that their earnings should be smaller? In all our examples so far the remuneration of workers has been assumed to vary with the effort required of them, and it would probably be thought Utopian to assume anything else. Nevertheless it is conceivable that all workers might receive a standing rate of pay for serving their industry to the best of

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their ability, irrespective of the hours they worked or the quantity of output, as most clerical workers do already ; and the results would not be essentially different from those already described. By improved methods the bootmakers, say, achieve a larger output, and this is found to be not required. They are thus able to produce the output that is required in shorter time. But this would give all the advantage of the improvement to the bootmakers. These, therefore, must reduce their staff to such an extent that, while some increased leisure is enjoyed by the rest, the total wage bill also permits a reduction in the price of boots. The bootmakers released (or the potential bootmakers not recruited) would go to assist in the production of some commodity for which the demand was growing, and whose producers were therefore threatened with an encroachment upon their leisure.

A general decline in demand as a whole would operate as automatically as it was seen to do where earnings varied with effort, given the same assumption that producers and consumers are identical. The smaller output required would not result in lower earnings ; but because the same costs of production would be spread over fewer goods prices would go up. The earnings of the producers would enable them to pay the higher prices for the smaller quantity of goods they now consumed, and as producers they would have more leisure.

Still, this might be very far from the result at which they aimed when reducing their consumption ; their intention may have been not to enjoy more leisure, but to work as hard as before in order to save money ;

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and they seem to have been frustrated because everybody has made the same attempt at the same time. But there need be no frustration, because production is not bound to diminish when consumption does. We saw that during a period of expansion production is always in excess of consumption, and so long as the cost of expansion is not allowed to be absorbed in the price of current output, saving is not only possible but inevitable. Similarly, it is clearly possible when demand drops to continue production at the former level by adding to stocks of durable goods, or by increasing fixed capital. Until these productions are consumed their costs will not appear in prices, with the consequence that producers must save some part of their total earnings and so achieve their object.

To expand the production of capital goods may not seem an obvious response to a general decline in demand; yet this condition is really the most favourable one to such expansion. For expansion not only permits saving, it requires saving, or at least a will to save, as a preliminary condition. This does not mean that an accumulation of money is required: money can be created at a moment's notice. What is necessary is either a store of commodities or a willingness to produce more than are immediately to be consumed. Under existing conditions these requisites to expansion take the form of a mass of unemployed labour and an accumulation of unsold goods, which are invariably present though not always in the same degree. Under the new conditions supposed there will be no workers involuntarily unemployed—society is presumed to have learned how to distribute its leisure better than

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that—but there is a willingness to work a longer week than is necessary to satisfy current demand.

But anticipatory production and capital expansion, in the absence of a revival of demand, can hardly be presumed to continue indefinitely, whether the desire to save does or not. Why should the desire to save continue? Who is supposed to be saving, everybody more or less in equal measure, or some greatly and others not at all? Certainly no economic system could be sound that required to discourage saving, but it does not seem obvious that a modern community should need to encourage it. One can easily imagine a social order that imposed no necessity to save upon individuals. On the other hand, the social system may be, and is to-day, such that some are almost compelled by the vastness of their income to save, while the rest must do so if they can in order to provide for their old age. Either system is compatible with the plan here proposed so far as it is yet outlined. Poverty indeed is unlikely; but an automatic and just provision of goods or leisure that meets the desire of each individual is by no means assured. It was shown to be possible by assuming an approximate economic equality between individuals. A considerable disparity in incomes might exist without destroying a common interest in the nature and quantity of output, but the greater the disparity the more widely will interests diverge; and if the basis upon which income is paid differs as between one class of person and another a productive policy equally favourable to all may be hard to formulate.

CHAPTER XII

PROFITS AND PENSIONERS

THE regulation of prices is likely to involve other changes which cannot easily be discussed without a departure from those purely economic considerations to which I have endeavoured to confine this book. Admittedly, the public control of credit and prices itself involves political measures; but what those measures are allowed to accomplish depends upon the extent to which we are prepared still further to interfere with existing practices and powers. Those who are indisposed to interfere at all must remember that a continuance of things as they are is a very improbable alternative to the changes here proposed. Changes of great importance, for example, are already being made in the organisation of industry, and their character renders them very relevant to this discussion.

For purposes of illustration, in the previous chapter we isolated the bootmakers and considered their relations in different circumstances both with consumers and with the producers of other commodities; but we did not separate one bootmaking factory from another. As a student of Guild Socialism between ten and twenty years ago I formed the habit of con-

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ceiving industry in a reformed society as organised into self-governing non-competitive units or guilds, each responsible for the complete production of a particular commodity or related group of commodities. While such a type of organisation is not essential to the regulation of prices, it does seem to me likely to follow it, as well as to ensure a more efficient use of the national credit. It does not involve, as the non-socialist critic is liable to suspect, a dangerous centralisation of power or bureaucratic methods of administration. In fact Guild Socialists found themselves antagonistic to most of the professed socialists of their day because of the vigour with which they condemned the undemocratic and bureaucratic concomitants of collectivism. The elimination of competition for markets between the different units of an industry is compatible with the continued existence of such units, each with a large measure of autonomy, each with a system of management appropriate to its own conditions, and with abundant scope for initiative and experiment.

In any case, industrial organisation is already moving very much in the direction indicated, though the ideas behind the movement are quite different from those which animated Guild Socialists. Rationalisation is a movement towards industrial integration and the elimination of competition; and if these ends are achieved while credit remains under private control and while financial profit is the aim of production, the consequences may be too evil to be borne.

In earlier pages we have been able without affecting our arguments to include profits among costs of

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production, or at any rate to lump them together. It is possible to do that if the money in circulation is constant. Profits can then be regarded as the capitalist's share of the sum withdrawn from the consumers, labour securing the other share. (Profits are here understood to include fixed interest and similar charges.) No matter whether the distribution is fair or not, the system is workable. These profits and these labour charges together on being distributed form the income of consumers, and are obviously sufficient to buy the product of industry priced at labour costs plus profits. Disputes may arise between workers and capitalists as to their relative rewards; no matter how these are settled, the total purchasing power of the consumers is not affected, and remains sufficient, and no more than sufficient, to buy the industrial output. Profits as a whole cannot be increased at the expense of consumers; they can only be increased at the expense of labour. Wages similarly can only increase at the expense of profits.

But money is not constant, and the situation described is not a normal one; it may exist for a while at the trough of a depression or at the crest of a boom; it will be destroyed in the one case by an increase in the volume of money and in the other by a decrease. In the former case profits may be raised without nominally reducing wages, and in the latter they may be lowered without nominally raising wages. But we are now presumed to have prevented these excess profits (and incidentally the converse "excess losses") by our plan of price regulation, and it would therefore appear at first sight that whatever profits are left must

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either be regarded as legitimate or at any rate as merely a matter of negotiation between labour and capital ; however they are apportioned, the system has become workable, the forces that have recurrently made it unworkable are no longer allowed to develop, and the division of the increment that is certain to arise in a society where expansion need no longer suffer periodical arrest would seem to be a matter outside the scope of such a book as this.

We might, indeed, let the matter stop there and settle itself, but it is as well to realise as clearly as we can what the difficulties are, and what depends upon the way in which they are overcome. For while on our imaginary island, where £2,000 had been circulating in the course of producing and distributing a few simple commodities, it was easy enough to see that the price of these commodities and the profits arising from their sale should not be affected by the issue of another £200, it is not nearly so easy in a real community, where commodities are many and money always fluctuating, to determine how much of the price of any particular commodity is legitimate profit and how much is profit derived simply because the money was there to pay it. Profits cannot in practice be separated into two portions according to the circumstances in which they are obtained ; we can only divide them if we have a theory of the basis on which legitimate profits may be calculated. In the absence of such a theory we must regard profit not as an item in the costs of production, but as the difference between those costs and what the producer can get from the consumer, and that, of course, is an orthodox view, or was once. But since

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we now propose to limit the producer's exactions from the consumer, we are in effect proposing not only the regulation of prices but the regulation of profits ; and unless they are to be regulated right out of existence we must know by what rule their proper amount is to be ascertained.

Now both in the popular mind and in modern economic thought a distinction is drawn between profits arising from the skilful husbandry of economic resources and those that arise adventitiously from scarcity, whether the scarcity is in relation to need or in relation to the quantity of money in circulation, and whether it is artificially produced by monopoly or otherwise. These adventitious profits have now been ruled out. It does not follow that the skill which makes two blades of grass grow where one grew before, or the enterprise that brings a gramophone or wireless set within the reach of everybody, should fail to reap a proportionate reward.

Yet when we look at the facts of industry to-day we are forced to admit that the question of rewarding the skill and foresight that increase production has no real connection with " profits " as normally understood and as normally distributed. For profits go to those who put money into a concern ; the skill that renders it profitable is supplied by managers and staff, who receive salaries, and directors who receive fees. There was a time when the two classes were much less distinct than they are now. A man put his own money into a small workshop or mill, and his profit was partly the reward of management and often also of his own labour. True, it involved the exploitation of other

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people's labour as well ; but so does modern industry. Where the new order differs much more essentially from the old lies in the greater separation of financial contributions to industry from executive and administrative ones. No longer is it the rule that a man who puts money into an undertaking should put effort and intelligence into it as well.

The clue we seek to the basis of a claim to profits is, then, not to be found in the managerial skill and resourcefulness that augment industrial productivity. That skill may be rewarded by higher salaries, by bonuses, by honours, or in any way we like ; the question is bound up with the general problem of remuneration for work of every kind, and need not long delay us here. It may be that a reformed society would move towards equality of payment, but no change of this kind is necessary to the practicability of the present proposals, though they would work more smoothly therewith, as we shall see ; neither do they preclude special monetary rewards being offered to individuals who effect improvements of organisation or technique if such inducements are required. These rewards, however, are not a return for monetary services, and accordingly are not the profits for which we are seeking a just basis. Are profits the reward of enterprise ?

Certainly enterprise is something different from that skilful use and improvement of economic resources which are becoming less and less a function of the capitalist as such ; and it seems also to be rather more than a mere loan of money. An element of adventure is usually associated with enterprise. A man risks his

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money in some undertaking of an experimental kind ; if the venture succeeds it adds to the world's available wealth, and the venturer becomes entitled to a special share of the increment, because if it fails it is his money that is lost.

Such private venturing, however, will clearly have no part in the industries affected by the proposed new economic policy. For while it may indeed be called an enterprise to put that policy into operation, it is not a body of shareholders that is required to be enterprising, but the nation. The success of each industry will depend upon two things : the efforts of the producers of all grades, manual, clerical, and administrative ; and the wise application of public credit. Neither of these factors can be affected by the present shareholders as such, and future financing will be carried out by the public banking system.

We are forced to conclude that, from the moment when the new order is established, no basis is left even for those "legitimate" profits to the calculation of which we have been seeking a guide. There is no principle whatever by which such profits can either be calculated or justified, and the problem that remains is simply that of deciding how existing financial claims upon industry are to be evaluated and met. Such claims can only be dealt with each on its own merits, and we may reasonably suppose that the settlement, unless it were part of a change forced upon society by a revolutionary crisis, would be effected by an issue of national securities of some sort to the existing shareholders.

Though still a charge upon the nation, capitalists

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will by this process be extruded from the industries reconstructed on the new basis. The personnel of each industry will consist entirely of active producers entrusted with the task of maintaining at the required level the output of a certain group of commodities. To accomplish this in a manner satisfactory to the consumers and by methods congenial to themselves will be their sole preoccupation. To make a profit is not their function. They recover their costs of production from the consumers, and a surplus in terms of money is a useless anachronism; it would indicate that they had withdrawn from the consumers more money than they had disbursed, and the products of some other industry must to a corresponding extent remain unsold. This might, of course, happen from time to time; the output of any commodity would normally show a margin above consumption, and if this margin were absorbed through a change in demand the producers would find themselves with a surplus of money—not, indeed, above what they had spent in producing the output sold, but above the amount they normally spent and recovered in a given period. At the same time the demand for some other commodity may have proportionately declined. If the change seemed permanent the units concerned would accommodate themselves to it in ways already suggested. A monetary profit would never be deliberately sought.

The payments made by way of compensation to the shareholders whose property is taken over obviously become a charge upon industry, either directly by entering into the costs of production, or indirectly by being withdrawn from the producers in the form of

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taxes. Though the terms cannot be discussed here, they are not a matter of indifference. For there can be no doubt that industry will continue for many years to grow more and more productive ; it is doing that now, in spite of the waste and the checks upon expansion that the present system enforces. Now this growth of production may be distributed to the consumers in the form of a continuous reduction in prices ; and if the payments made to the bondholding class were fixed in nominal amount they would constantly grow in real value.

This may not seem an important objection ; what is of more moment is the power that this class might continue to exercise, if its receipts formed a substantial portion of the national income, upon production. For the bondholders might be unable or unwilling to spend all their income, and a persistent and uncompensated decline in demand from this cause would eventually entail reduced production, just as it does to-day. If the remuneration of producers varies directly with output, as we have generally assumed, a reduction in their income will follow, though they may not in the least desire to curtail their own consumption. Still more important is it to note that, though the reduced wages bill would involve a fall in the cost of total output, the price per unit of output would rise. For labour charges are only a part of total costs ; the payments to the bondholding class itself form the other part, and these are assumed to be fixed interest charges, or at any rate not varying with output, with the consequence that when output is reduced each unit must bear a larger part of these fixed charges among its costs. The result

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is that not only do the incomes of the producers fall, but each pound will purchase less than it did before.

Suppose the national income can be represented by £12, of which the producers receive £9 and the bondholders £3, and output is 12 units of goods. Then costs of production are £12 and the price of each unit £1. The producers between them can buy 9 units and the bondholders 3. If the bondholders refrain from spending £1 of their income, by consuming only 2 units, and production is reduced correspondingly to 11 units, then the producers will receive only eleven-twelfths of £9, or £8 5s. But the bondholders continue to receive £3, which is fixed, and the total cost of producing 11 units is therefore £11 5s., and the price of each unit rises from £1 to approximately £1 os. 5½d. It will be noticed that although the producers have turned out 9 units for themselves as usual, they cannot buy them all, for they have not enough money.

If we suppose that wages also are fixed in amount, whether the output required of workers is small or large, then 11 units will cost £12, and the price per unit will rise from £1 to nearly £1 1s. 10d. Again the workers will be unable any longer to buy 9 units.¹

This situation is common enough, and it presents itself to the entrepreneur as a hint to dismiss some of his staff and lower the wages of the rest. Instead of

¹ The result is, of course, the same if the interest charges are paid out of taxation instead of directly entering into industrial costs. If wages are constant a reduced output will mean a higher price per unit. If they fall with output, prices will certainly fall as well, but the producers must provide the same taxes out of a smaller income, thus reducing the amount they can spend on goods.

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dismissals, we must suppose that in our reformed society shorter time is worked by all. In a very limited sense it may be true to say that there is no injustice, for although the workers can buy less they also do less work. But in the same sense it might be argued that an unemployed man may justly be allowed to starve because he does no work at all. It is not necessary to have clear views upon the notion of the common inheritance to be repelled by such an argument, and one does not often hear it nowadays. We can be quite sure that in a more justly ordered society no man will be compelled to go short simply because other men desire to.

The difficulty might be surmounted by raising wages to a point at which, even after the inflationary effect of this upon prices is taken into account, the producers are able to buy as much as they formerly did. This will, of course, raise prices to a still higher level than that to which they were inevitably raised as a consequence of reduced demand. (For every rise in wages increases costs and so raises prices again. Using the same symbolic figures as before, total wages must be raised to £13 10s. to restore the purchasing power of the producers. Total costs are then £16 10s. and the price of each of 11 units is £1 10s., enabling the producers with their £13 10s. to buy 9 of them.) This method of preventing hardship to the producers differentiates against the bondholders, whose fixed income will purchase less than it did before. And it will be observed that neither this differentiation against the bondholders nor the former one against the producers can be remedied by ensuring that the payments to

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bondholders shall vary with prices. For no fall in prices took place in the former case to justify a reduction in the non-productive charges ; and if when prices are raised to enable the producers to maintain their standard of living the bondholders must also receive higher increments, then the costs of production are raised once more, necessitating still higher prices, and again the producers are worsted.

There appears to be something resembling a Euclidean absurdity about the whole position, and if we examine it in terms of goods the absurdity becomes plainer. Suppose, as before, that a quarter of the national income goes to bondholders and three-quarters to producers, and that the total income is represented by 12. Suppose next that this is paid in produce, and that the produce consists entirely of loaves of bread. Then 12 loaves of bread are made per day, of which the producers consume 9 and give 3 to the bondholders. These 3 loaves are a fixed debt due each day from producers to bondholders.

Now suppose that the bondholders intend for a time to *consume* only 2 loaves per day, and that by some means (corresponding to an abstention from spending money) they can announce this intention to the producers. Then there seems no need to make more than 11 loaves per day in future. Yet, simultaneously, there *is* a need to make more than 11 loaves, because the producers must still pay 3 per day to the bondholders, for that is their obligation. If they make only 11 loaves they cannot both pay their debt to the bondholders and consume 9 loaves themselves.

This absurdity, it should be remarked, is not peculiar

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to the imaginary situation we have created. Something very similar is a fact of ordinary economic life. For a man who invests his income instead of consuming it is simultaneously instructing industry to produce less and to produce more. But the illustration not only reveals the absurdity ; it also makes obvious the solution. It is one that we have mentioned before in similar circumstances. Production need not decline because demand has ; true, we cannot accumulate loaves of bread, but we can increase our stocks of durable goods and add to our instruments of production. Thus we build up a store of undistributed wealth equivalent to the money that we must continue to pay the bondholders whether they wish to spend it or not. This store of wealth ensures that there will be something for them to spend it on when they so desire.

The solution has a certain logic, then ; yet taking a broader view it is less satisfactory, for it seems to be a system of setting people to work not primarily to provide goods but to distribute money. To such wayward courses we shall have for a time to reconcile ourselves ; they arise from the essential unreality of money, and are most marked where its distribution is most unequal. For money, which is a claim upon goods and services, can be accumulated and stored indefinitely, but goods and services cannot. Society can most conveniently deliver goods and services to its members at a stable rate ; certainly it must be prepared within the limits of its capacity to vary this rate according to the requirements of consumers, whose satisfaction is the object of production. But the more widely the distribution of money differs from

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that of the need to consume, the more certain is the productive system to meet with embarrassments.

We have so far assumed that the payments of interest to bondholders whose property has been taken over are a direct charge upon industry, entering into prices, or—what amounts to the same thing in effect—recovered in taxation from the consumers. It is possible in theory to avoid both these alternatives. Interest payments may be made with new money ; that is, they may be pure creations of credit. They will not in that case enter into the costs of production or into prices. Prices will be made up of labour charges only, and total prices will be equal to the income of all the producers. The producers alone will then be able to purchase all the goods produced. But the bondholders have also received money ; therefore more money is in circulation than there are goods to spend it on.

Now we had a somewhat similar situation before, when, during a period of development, and because of the effect of our system of price regulation, the money disbursed in a given time was greater in amount than the prices of the consumable goods created during the same time. But in that case the surplus money was at any rate represented by capital goods ; that is, by the capacity to produce consumable goods. In the present case the surplus money is not represented by anything, for the producers' income alone is sufficient to purchase not only their output of consumers' goods but that of the new capital goods as well. In fact money has ceased to have any relation to goods, and the method must be regarded as impracticable, besides being

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especially repugnant to a society that is presumed to have recognised the importance of a proper relationship between money and prices.

Perhaps in practice the even flow of production and distribution may suffer less disturbance than is here anticipated. If it does not, the disturbances can be coped with in ways already outlined. The reason why the incomes of the bondholders seem likely to have this disturbing effect upon our reformed society is because they are so large, and they are presumed to be large because they are so to-day. That these incomes are unearned is not the objection; the economic system will have to accommodate itself to an increasing number of incomes that are unearned in the sense that their recipients no longer render any economic services to the community. For as productivity increases there is certain to be a gradual lowering of the age of retirement. This does not mean that large numbers of men will be compulsorily idle; it means that they will be detached from the organised machinery of material production.

Almost as certain is it that the incomes of retired producers will take the form of pensions. This need not be so; everybody could be expected to save enough money during his working years to maintain himself afterwards. But the community certainly cannot save during the first portion of his life the goods that he will consume during the second; and the sort of society we are contemplating will regard it as sensible, without making an iron law of it, to distribute money at the time when the goods it is intended to buy are produced. The number of consumers not connected with the pro-

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ductive organisations will in time be large ; we have already seen, however, that the conflict of interest between consumers and producers can be reconciled in a manner reasonably satisfactory to both. Producers and pensioners will not feel themselves to be two different social classes, and their incomes will not widely differ in amount.

Incentive to save money will grow weaker. This is as it should be, for hoards of money are of no advantage to society. Hoards of goods are, but the capacity to hoard goods is limited. Beyond these limits goods must be used as they are produced, and if through some catastrophe a community's power to deliver goods diminishes, no amount of hoarded money will avail its members. Yet a modern community does not live altogether from hand to mouth ; moreover, the right of an individual to do what he likes with his income, short of injuring others, needs to be preserved. Saving through fear of poverty will be no more. Saving through sheer inability to spend an income too vast for any man's requirements will also, we may hope, disappear through the disappearance of the class so favoured. But it does not follow that there is no purpose to which individual savings may be usefully applied, or that our reformed society will have no room for what may justly be called private enterprise.

The major industries, it is true, will not be controlled by private enterprise ; these include those that provide the nation's prime necessities and those whose products are necessary to all the rest. The public regulation of these great industries and the elimination from them of private profit will not only ensure a

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reasonable standard of living for everybody, but it will give to society its distinctive economic character, which will not be destroyed by the presence of a multitude of independent enterprises conducted on very different lines and subject to no public interference. The motive of these enterprises may be private profit. In many cases that motive will be almost absent ; the enterprise will spring from an eagerness to execute some cherished plan upon which its designer will spend his money and energy as freely as others spend them upon their gardens or their golf, and with as little thought of gain.

From this it does not follow that private enterprise will be merely the amusement of leisured men and its product of no importance. Certainly the nation will no longer depend for its essential supplies upon the irresponsible efforts of private individuals or corporations governed simply by the desire of profit. Yet quite serious undertakings may be started by private groups as the population secures more leisure. Publishing is an obvious example of an industry that had better be left to private enterprise than brought under public control. The system will probably permit cranks to thrive more easily than they do now. While not a serious evil, this would not be a particularly good thing were we certain to recognise a crank when we saw one and never to apply the label to an ingenious and useful citizen. Since we have no infallible test of a crank, and those called cranks often prove to be valuable members of society, it is truer to say that our system will restore individuality by the widespread distribution of economic freedom.

CHAPTER XIII

FOREIGN TRADE

ANY economic plan that requires changes in our monetary system will be suspected of a liability to disturb foreign trade. It is right that the effect on foreign trade of any such change should be considered, but wrong to presume that it is bound to be evil, though that is the presumption to which people seem always most ready to incline.

Foreign trade, as everybody knows, is an exchange of goods and services between one country and another ; in foreign as in home trade, money is merely a device for facilitating these exchanges. To any country's merchants collectively foreign trade is a matter of both exports and imports, though from the point of view of a particular trader either an export or an import by itself may be of sole consequence. A manufacturer of motor-cycles, for example, may be vitally concerned with the willingness of foreigners to buy his machines, and not at all concerned with what foreigners desire to sell to his countrymen. To the nations, however, imports alone form the essential part of foreign trade. Food we must obtain from abroad in order to live, and raw materials if our

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manufactures are to thrive. Our exports serve only to pay for these. True, the exporter of motor-cycles or coal does not accept payment in wheat or cotton ; he accepts a credit of some kind that he can convert into the money of his own country. But the credit instrument so converted will be used by the dealer in exchange to pay for an importer's cotton or wheat. Credit instruments are of no value unless they can be so used to pay for other goods or services.

Since these various transactions between home and foreign merchants are conducted independently of each other, either imports or exports may for a time exceed the other. We do not as a rule distress ourselves when exports are the larger ; on the contrary, we rejoice ; foreign countries have become our debtors ; our credit is good. But when imports predominate, though these are what we essentially desire, we grow anxious. We do that not because the imported commodities are unwelcome, but because they have to be paid for somehow or they will cease to come, and if foreigners are not buying our own goods the means of payment will be lacking. For even gold is not a means of payment after our stocks of it are exhausted. Any new gold we import must be paid for ultimately in goods, and if our goods are unacceptable gold miners will no more send us gold than foreign farmers will send us wheat or planters cotton.

Certainly this country would have a long way to go in the direction of commercial decline before a refusal by foreigners to supply us with goods became more than a theoretical possibility. Our own exporters are eager enough to sell their wares in all parts of the

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world ; why should foreign exporters be less eager to sell theirs to us ? They will not be ; yet the eagerness of foreigners to sell is not sufficient to ensure a continuance of imports. Their inflow may be checked, in the first place, by our own monetary policy.

For if we have a free gold standard an excess of imports will be paid for by gold, and to maintain our store of gold the Bank of England will curtail credit. This action, as we have seen, lowers home prices, thus encouraging us to buy home products rather than foreign ones competing with them. But it only accomplishes this by reducing the total volume of money in circulation at home ; we have less money to spend upon all goods, including those foreign goods which do not compete with home products. Relatively to our lowered spending power foreign goods have become dearer ; the banks have discouraged imports by making them harder to buy.

Yet to obtain those imports is the ultimate reason why we engage in foreign trade at all, and to make their acquisition harder is of no obvious advantage to ourselves. That the gold standard does this for us would not be advanced as a merit by its most ardent supporter, who would, however, urge in its defence that the check thus imposed at an early stage upon excessive imports would in any case be imposed later by natural economic forces. For if there is no gold standard to be maintained, then the excess of imports, by producing an enhanced demand for foreign money with which to pay for them, will cause the pound sterling to depreciate, and the price we must pay in our own money to satisfy the foreigner in his will rise.

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The method of credit restriction can, of course, be adopted whether there is a gold standard or not—though the inducement is not so great in its absence. In either case the effect is the same; the purchase of foreign goods becomes more burdensome; and it is not the restriction of credit that makes it so, but the fact that we are importing to excess.

But what exactly is an excess of imports? Clearly they are not in excess of our requirements or we should not have imported them. Foreign goods are ordered, as any goods are, by people who want to use them in one way or another. We say that the excess is revealed by a comparison between our imports and our exports. But we cannot compare unlike things; we cannot say that a given quantity of crude oil is greater than a given quantity of tweed cloth. What we can compare, however, is their price; and by an excess of imports we mean that we have imported goods whose total price is greater than that of the goods we have exported. Speaking arithmetically (and, of course, quite absurdly from a practical point of view), the disequilibrium between exports and imports could be corrected by charging more for our exports. Such a solution would be possible if our exports consisted of goods which we alone produced and everybody else required. As it is, our deficiency of exports must be presumed to arise not because we charge too little for them, but because we charge more than foreign customers are prepared to pay, or more than they are asked to pay by other sellers, from whom therefore they buy instead of from us.

Now price is, after all, inseparable from quantity;

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it is the sum which a customer pays for a given quantity of goods. More fundamentally, it is the quantity of goods that he exchanges for a given quantity of goods of another sort. If, therefore, a nation is threatened with a difficulty in obtaining essential imports because the goods it offers in return are not considered adequate in volume, the obvious remedy is to increase their quantity. In other words, it must offer more goods for the same money. To do this it must produce more. But that is exactly what the present method of correcting an unfavourable trade balance prevents.

For a curtailment of credit means idle machines and unemployed workers, whereas what is required is greater industrial activity; and this is true whether we think in terms of goods or money. For under modern conditions a large output is nearly always more economical than a small one, and permits lower prices. Certainly there may come a point where a factory could not increase its output without a disproportionate increase in costs, unless the increase in output were large enough to justify capital extensions. But this problem only arises when a factory is already working to capacity. No manufacturer would expect to be able to reduce his costs and undersell his competitors while much of his plant were idle, and most of his overhead charges remained; and that is the position in which a nation's producers, as a whole, are placed during the slump which a contraction of credit brings about.

Now, if the arguments put forward in previous chapters are sound, it has been proved that slumps

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can be prevented ; that so long as goods are required for any purpose whatever, men and machines can be kept busy producing them. Nothing more need be said to show that in our foreign trading we should at any rate be better off than we are now. But more can be said.

An expansion of credit, as the reader must be tired of hearing, at present permits prices to rise. This rise in prices is one of the causes of increased imports, and therefore of a tendency towards an outflow of gold. By regulating prices, instead of permitting them to vary with the quantity of money, we prevent the rise due to an expansion of credit. Thus, although the preservation of the gold standard is no concern of ours, one interesting consequence of these proposals is that the maintenance of the gold standard may be made easier rather than harder.

We are not, however, prepared to make sacrifices to this end, and we must see what happens if, despite our regulated home prices, goods are imported to excess and we owe more than we are owed. Such an excess, we said just now, would lead in the absence of a gold standard to a depreciation of our currency. That is what happened during and after the war. While Great Britain and America both adhere to the present gold standard the pound sterling is worth 4·866 dollars, and cannot fall below that value by more than a cent or two. Between 1914 and 1925, however, our pound was often worth no more than four dollars, and sometimes considerably less, and American goods in our money cost more. This would generally be regarded as the normal consequence of

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an excess of imports, assuming that we refused to export gold, or had none left to export.

A depreciation of currency, one may remark, takes place through a form of profiteering. The debts owed abroad by British importers have increased; merchants are clamouring for the means of payment. These means are the credits obtained from foreign debtors by British exporters, and sold to dealers in exchange. But the quantity of these credits has become less than the demand for them. Dealers in exchange are able, therefore, to charge more for a given quantity. They make a profit in excess of their normal commission or discount, just as a shopkeeper or manufacturer does when he raises prices in face of an increased demand for commodities.

From the standpoint of social justice there is a difference, we may grant, between raising prices through increased demand and raising them through reduced supply. Shopkeepers and money-changers must live, we may assume, and if their stock of goods or credits is reduced, their standard of living can only be maintained if they reap the same profit as before on a smaller turnover, which means charging more per unit. The same defence is not available when fortuitous profits are made by exploiting a growth in demand, and one virtue that the gold standard has is that it confines profiteering in exchange to very narrow limits.

It must be borne in mind that the depreciation of currency does not in itself correct the adverse trade balance which permitted it. A man who now has to pay £105 to settle a foreign debt that he formerly

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settled with £100 is not settling a larger debt. The foreign credits held by a dealer in exchange will only settle a certain amount of debt in their country of origin, no matter how much he charges merchants for them. The adverse balance will remain until goods or services are sold abroad to pay for them, and no amount of juggling with exchange rates will clear it otherwise.

This, however, is rather a diversion. For we do not pretend that we can stabilise our exchanges simply by regulating the profits of our exchange dealers. London is not the only money market in the world, and credits with which this country is concerned are by the very nature of the case affected by influences and the actions of people outside its control. Nor do we suggest that an unfavourable trade balance would be rendered any easier to correct by preventing a depreciation of currency. What, then, is the position?

The position is that by adopting a saner economic policy we have greatly improved our ability to sell goods in foreign markets, and greatly decreased the likelihood of an adverse trade balance arising. But we have now to assume that an adverse balance has nevertheless been created; we have imported more than we have exported. This fact taken by itself need not disturb us: our importers are getting what they want. Our exporters, however, are presumably experiencing a shortage of demand. This also can be dealt with easily enough as an isolated fact under our proposed plan. Those industrial units which produce partly for export can submit to smaller incomes and

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enjoy greater leisure, if this does not lower their standard of living more than they like, or they can reduce their staff and share their leisure with other units. If the leisure is shared equally among all producers in these circumstances it amounts to a pure gain. The same quantity of goods as before is produced for home consumption, and nobody is any worse off through the reduction of foreign demand. Apparently, then, there is no inducement to correct the trade balance.

This only remains true, however, while imports continue to arrive in undiminished volume, allowing the balance against us to accumulate. We cannot suppose that this will go on indefinitely; and as we must assume that other nations are for the present conducting their affairs by the old methods rather than the new, we must anticipate the old reactions. Foreign producers will not suddenly cease to send us goods till we have paid our debts. What will happen instead is a depreciation of sterling and a consequent rise in the price of imports.

At home, therefore, the purchasing power of our incomes will be reduced; all those goods into which foreign products enter will cost more. Here, then, is the inducement to relinquish that additional leisure we had temporarily gained. We can no longer enjoy it without diminishing our consumption of goods. Regarded from the standpoint of individuals, the cost of living has gone up, and many will wish to earn more money and be willing to work longer in return. Most of us may take no broader a view of the situation than this, though it is more likely that an understanding

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of the national aspect of such problems will become general. Regarded from the standpoint of the nation's Economic Parliament, if there be such a body, the position is that we had now better consider the desirability of producing for ourselves those goods which we only imported because they were cheap, and at the same time lower the prices of those of our exports which we can most easily sell abroad in order to sell more of them and pay for the foreign goods that we cannot do without. The individual's will to increase his effort and the nation's need to increase its output thus arise from the same cause and are satisfied by the same measures.

And there is nothing to prevent those measures being adopted. For the ability to sell in foreign markets sufficient goods to pay for our imports depends, it is worth repeating, entirely upon quantity and quality of output, and these are a matter of natural resources, productive equipment, and human effort and ingenuity. They are not a matter of money, though money can become an embarrassing factor through a defective economic system.

In presuming that we have removed the monetary hindrance, we do not suggest that the operation of selling goods in foreign markets has become any less exacting. It continues to exact effort. But the difference is that the effort can now be made. We shall no longer be confronted with the strange combination of an urgent need for more goods and a large mass of unemployed workers.

If we are asked to contemplate an extreme case, and to suppose that foreign nations are prepared to

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work themselves to skin and bone rather than allow us to undersell them in the markets for which we compete, then we can only say that we shall at any rate be no worse off than we are now. We do not pretend that our plan works miracles. In such circumstances we should be thrown back more and more upon our own resources, though with a far greater freedom and ability to use those resources than we possess to-day. But there is a ray of brightness in that gloomy sky: this tremendous zeal on the part of foreigners to sell goods for next to nothing is in our favour as consumers. If we are able to import anything at all it will not cost us much.

Fortunately, the situation is too fantastic for serious contemplation. Moreover, while it would be a grave defect in any economic system that it would only work if other nations adopted it too, and ours is not of that kind, we can hardly suppose that the rest of the world would long submit to an evil social order when a better had been found; nor is it reasonable to assume that co-operation between nations is a Utopian ideal that can never be realised. Co-operation of a sort is proposed vaguely now and then as a measure of despair. Debtor countries cannot pay their creditors except by underselling them or each other. A sound economic system will permit a creditor country to receive debts in goods without injuring its own producers.

CHAPTER XIV

CONCLUSIONS

THE object of this inquiry was to discover the causes of poverty and industrial depressions, and to devise a way of preventing them ; and we started by observing that poverty and an abundance of goods were present in society at the same time. This conjunction is not in itself a paradox, but is made so by the fact that the rich do not desire to consume all the goods there are, and that the producers of goods seem as anxious to distribute them as the poor are to obtain them. But to distribute goods in this sense means to sell them, and to obtain them means to buy them ; and thus we were led to look for some monetary cause of the failure to distribute.

Here we were confronted by two hypotheses : (1) the phenomena to be explained are consequences of the unequal distribution of money ; (2) that all the money in circulation, however distributed, is insufficient to buy all the goods produced at prices based on costs. We have found that the first of these hypotheses is no more than a partial explanation of what takes place, and that the second, while it certainly states a condition that does arise, is not permanently

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true. Our own conclusions concerning the monetary factors in the problem may be thus expressed :

(1) By contracting credit, and thus reducing the community's spending power, the banks can and do cause industrial depressions, signalised by unemployment and a falling off in demand.

(2) The same results ensue when savings increase. This might be corrected by an equivalent expansion of credit, but the principles upon which credit is at present controlled may not permit expansion precisely when this contingency occurs.

The problem would be simpler than it is did these two factors operate upon a society otherwise static. Instead, they operate upon a society that is subject to change in two other respects, population and productivity, and thus we reached these further conclusions :

(3) Growth of population, which the community's productive resources are assumed to be capable of supporting, demands an expansion of credit. It is not enough, therefore, that credit should never decrease in amount. Unless it increases adequately the absorption into industry of the increment of population may be retarded.

(4) Within a capitalist and competitive system any decrease in demand relatively to supply may cause unemployment. So may the success of a productive unit in reducing costs ; for this unit may reduce prices and put its less efficient rivals out of business. These causes, however, are really a form of the second factor enumerated ; for the advantages of the enhanced efficiency exist in monetary form somewhere, either as

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increased profits gained by the successful producers or as unspent purchasing power gained by consumers through the lower prices of the commodities affected. Only if the money is saved does demand as a whole fall off. Nevertheless, changes in the way the money is spent may cause depression in particular branches of industry through the imperfect mobility of labour.

The economic situation at any time is mainly the product of these four factors. It is not easy to separate them in practice or to estimate their several effects. Many reformers regard credit as the only important factor. Certainly the control of credit can be so exercised as to produce all the evils we sought to explain, just as it may either correct or augment the consequences of the other factors. It may also induce those factors, for people are influenced in their ways of using money by the ease or difficulty with which it is obtained. Bank credit, in fact, we found of great significance; prosperity grows with its expansion and decays with its contraction.

Our proposals, however, do not require us to disentangle the effects of changes in the volume of credit from those of changes in the rate and course of expenditure. Both take the form of fluctuations in productive activity, and the task of estimating their relative weight may be left to those who regard the problem merely as that of preventing or minimising those fluctuations by varying the quantity of money, leaving merchants and manufacturers free to grasp as much of what is issued as they can.

We for our part do not seek to prevent these fluctuations. In so far, indeed, as they arise from involuntary

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diminutions of effective demand enforced upon consumers by purely monetary causes they will be prevented far more surely by the measures we propose than by those just described. But fluctuations may arise from changes in real demand, to which industry within its capacity must respond. A rise in real demand should not be rendered incapable of satisfaction by a deficiency in money ; therefore we must control credit. A decline in real demand should be interpreted, and be capable of being applied, as a sanction for more leisure ; the instrument by which we ensure this is the regulation of prices.

It is not, admittedly, so perfect an instrument for the purpose as it would become if aided by appropriate changes in our economic structure and by a levelling up of real incomes. But to these changes it is the key ; and even alone it will remove one of the most potent causes of present disorders. For our analysis revealed, in addition to the factors already enumerated in this summary, one other of no less significance : the licence enjoyed by entrepreneurs when credit expands to raise the price of goods with whose production its issue had nothing to do. Applied merely as a ban on profiteering in the sense defined, the control of prices will achieve far more than the mere prevention of unjust profits, for it will prevent also the repercussions by which the means employed to reap those profits strike back at the classes that employ them and at society.

To regulate prices was regarded in the Middle Ages as a perfectly normal and necessary proceeding. What the medieval craftsman or merchant meant by the just price he may not have been able to explain in the

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language of modern economists ; but he knew that it was possible to be fair in fixing the charge made for a product of human effort, and he knew that it was possible by trickery and dishonesty to be unfair. So he set up standards of workmanship and of commercial conduct, and prevented or punished failures to observe them.

The industrial revolution brought an era in which prices were allowed to look after themselves. It became an article of economic faith that they should not be interfered with by authority, though even in the nineteenth century there were writers who foresaw that this would not always do. In the twentieth century great authorities perceive at last that prices cannot be allowed to go their own way. These authorities are not indeed concerned with the fact that the customer or the workman may be robbed ; what has led to their change of attitude is the realisation that uncontrolled prices lead to general disaster. They therefore propose a complicated series of checks and adjustments and stimulants and brakes whereby prices are to be controlled in much the same remote way as that in which Mr. Heath Robinson's top-hatted old gentlemen crack an egg.

We need not withhold our admiration for the ability with which the Macmillan Report has been prepared if at the same time we deplore the timidity of its recommendations. It may be better that the complicated operations of banking policy should be avowed, systematised, improved, and directed more deliberately to recognised aims than they are to-day, rather than they should continue to be performed behind a

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veil by nobody knows whom ; but none can regard such puny reforms as appropriate to the needs of the age.

Prices must be controlled, but not through the manipulation of credit ; credit must be controlled, but not for the purpose of acting on the price level. Our proposals for regulating prices have been dealt with in some detail. Little has been said concerning the control of credit save that it should be issued as freely as it can be usefully employed. This, indeed, is the principal requirement of a satisfactory credit system ; but what it means in practice may not be quite the same during the earlier years of the proposed new policy as after its complete establishment.

To lay down very rigid rules would be unwise ; but we may be sure that any circumstances in which such a policy is likely to be adopted will at first require liberal advances of credit for the reason that there is bound to be a good deal of unused productive capacity. Indeed we might say that the mere presence of large accumulations of unsold goods, which many people need but cannot buy, is itself a justification for issuing more money, however loudly the word "inflation" may be cried by those who can only contemplate one idea at a time. Be this as it may, a large expansion of credit, accompanied by a temporary stabilisation of prices, will be the first steps. In time all our productive resources will be as fully employed as we wish them to be. Thereafter credit need only expand as population grows, and if population neither grows nor declines there is no reason why the volume of money in circulation should vary. The result will be a stabilisation of

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the community's income in terms of money, and a progressive increase in its purchasing power so long as the rate of production continues to rise.

If we may suppose that industry under this plan will eventually be carried on by corporations or guilds responsible to the public, what we have continued to call credit will take on a somewhat different character from that which it possesses to-day. We have already learned to think of it as money; we shall then cease to regard it as a loan due to be repaid to somebody and cancelled. Once in circulation it will remain in circulation, unless a decline in population renders a smaller volume of money sufficient.

This at any rate seems the simplest and most logical method of regulating the issue of money, though it is not the only way compatible with the remainder of the suggestions here put forward. I do not pretend to have described all the ways in which the dual control of credit and prices may be profitably exercised, or all the adjustments and kinds of co-ordination that may be required in different circumstances to secure the greatest good. The plan at its best is an instrument for securing economic justice and by that means freeing society from an anxious preoccupation with economic problems, which have assumed a disproportionate place in the outlook of mankind; but how it may best be used for this purpose depends upon what our notions of economic justice are. These may change.

The proposals I have outlined seem to me to be thoroughly workable, not only in the sense that they hold together, but also in the sense that their adoption will require no violent reversal of current industrial

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tendencies or exact from human beings superhuman habits or virtues. Of these drawbacks any large plan for the social good is bound to be suspected. If one suggests that a group of mills and factories should be co-ordinated and called a guild, and their work organised for the advantage of society, one is condemned as visionary and unpractical. If the same mills and factories are co-ordinated in precisely the same way and their work carried on for somebody's personal gain, the process is called rationalisation, and considered perfectly practicable and by many entirely laudable. If we recommend that prices should be regulated according to costs by a public authority, the scheme is called fantastic and impossible. If we hear that the price of petrol has been changed by the edict of a group of anonymous persons, no one feels the least surprised when every retailer in the country charges the new price within twenty-four hours.

We read almost every day of inventions and improved processes whereby new commodities can be made for our enjoyment, or old ones produced many times more easily than before ; yet we never expect much from these facilities except trouble ; and it may take some of us quite a while to believe that everybody can be very comfortably off. Such a prospect, we feel, must be remote from our time and habitudes, and off go our imaginations, projecting us into an age peopled by a race wearing strange garments, having little to do but play harps and tabors, and in disposition too angelic to be comfortable companions for poor sinners.

But the reader should not be thus dismayed ; the control of prices will not alter our natures or habits

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to that extent. Many anomalies, inequalities, inefficiencies, and so forth would persist long after the new order had begun to bestow its benefits, which indeed would accrue at a very early stage. In our offices and workshops we should find much the same people as we find now ; there would be clerks, managers, craftsmen, technicians, accountants, and so on, earning no doubt various salaries. Outside there would be classes deriving incomes from securities, with rather more confidence in their continuance than many of them can have felt of late, though arranged on a basis, we may hope, which in the course of a generation or so will lighten the burden of such charges upon society. We should still wear coats and trousers ; our dispositions would continue to be short of angelic ; and harps and tabors would not provide our most popular music.

These proposals, then, do not profess to produce a society better than men desire it to be ; but what they will ensure almost from the first moment is that goods which can be produced can also be distributed, and that a man who desires to produce them will not be debarred by the poverty of others. That this represents a vast transformation in the circumstances that surround us to-day is a strange thing but true.

CHAPTER XV

DEFECTS OF THE DOUGLAS THEORY

MAJOR DOUGLAS began to expound his theory immediately after the war, mainly in the columns of the *New Age*, then edited by Mr. A. R. Orage. It has won the support of an enthusiastic group. Since the proposals advanced in this book took shape in the course of an attempt to understand and interpret Major Douglas's, and resemble them in requiring prices to be directly controlled, perhaps it is fitting that I should try to show where, in my opinion, the Douglas theory fails.

The payments made by a productive organisation are divided by Major Douglas into two groups :

"Group A—All payments made to individuals (wages, salaries, and dividends). Group B—All payments made to other organisations (raw materials, bank charges, and other external costs)."

From this classification he proceeds to the following theorem :

"Now the rate of flow of purchasing power to individuals is represented by A, but since all payments go into prices, the rate of flow of prices cannot be less than $A + B$. Since A will not purchase $A + B$, a

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proportion of the product at least equivalent to B must be distributed by a form of purchasing power which is not comprised in the description grouped under A."¹

A possible interpretation of this theorem is the situation described in the first few pages of Chapter VI. The hardy reader who again refers thereto should beware of a possible misunderstanding. He must not regard the wage payments made by the two factories as the A and B payments respectively. The £1,000 which Factory Supplies and Household Goods each pay out weekly to their staffs are both A payments. The B payments are those made by Household Goods to Factory Supplies for semi-manufactures.

The goods ready for sale to consumers in any week have cost £2,000, half of which sum has just been paid out to them by Household Goods and can be spent. The other half reached them a week ago from Factory Supplies, and was spent on goods that have now been consumed. It is only because another £1,000 happens to have been issued through Factory Supplies for further work that £2,000 is now available.

If this is what Major Douglas means, his A + B theorem does not correctly express it. The theorem professes to show that the rate of flow of prices is necessarily greater than the rate of flow of purchasing power. The two rates must obviously be compared at a given moment. (For if we compare prices now with the purchasing power disbursed while those prices were made up, both prices and purchasing power will

¹ *The New Age*, May 2, 1930. See also *Credit Power and Democracy* n. 21.

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necessarily equal $A + B$, which the theorem denies.) But whereas at any given moment purchasing power equals A , as Major Douglas says, prices do not equal $A + B$: they equal $\frac{x}{A} + B$. In other words, the price of Batch C does not include all the A payments in the hands of the consumers at this moment, but only a proportion of them—namely, that proportion just distributed by Household Goods. Those of the A payments just distributed by Factory Supplies for work on Batch D do not figure in the price of Batch C, though they are available to buy it.

The Douglas theory cannot be sustained, therefore, if it means that the consumers' purchasing power is necessarily below the cost of unsold consumers' goods. But an alternative interpretation is this: the money in the hands of the public at any given time ought to be sufficient to purchase all the goods there are, whether consumable or capital goods, but in fact is insufficient. "The product of any factory," Major Douglas writes, "may be considered as something which the public ought to be able to buy, although in many cases it is an intermediate product of no use to individuals." ¹

Referring again to Fig. 1 (page 62), we find our consumers with £2,000 in their pockets ready to be spent. In the distributing department of Household Goods we find £2,000 worth of goods ready to be sold. But in Factory Supplies' warehouses we find at the same moment half-finished goods to the value of £1,000—Batch D in its first stage of manufacture. Do not these goods also belong to the community that has

¹ *Credit Power and Democracy*, p. 21.

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produced them? The community may not want them, but has it not the right to them if it does? If so, the right should be implemented by the money with which to buy them, and that is not present, for all the money available is required to purchase Batch C.

Certainly the community, in the persons of those employed by Factory Supplies, has produced these semi-manufactures called Batch D. But for doing so these persons have received £1,000, which is Batch D's selling price; they have the money at this moment; they can buy Batch D if they like. Instead, they choose to spend the money on Batch C. True, they also helped to produce Batch C, but their reward for doing that was spent on Batch B, and their earnings on Batch B were spent on the preceding Batch, and so on. We must either go back in this way to infinity, or assume that at some point the community enjoyed an original Batch that descended from the skies or was bequeathed to it by its ancestors, in which case Batch D, half-finished, represents the wealth which it, in turn, leaves for posterity. No right to enjoy Batch C and Batch D simultaneously appears to be established. The same conclusion may be reached by asking what the community has produced since last it received payment. It has produced semi-manufactures worth £1,000, and it has increased by £1,000 the worth of earlier semi-manufactures by converting them into finished goods. Its contribution to the communal wealth is therefore £2,000, and that is what it has received.

If, however, more labour than usual is applied by

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Factory Supplies to a certain week's semi-manufactures, and their cost value rises from £1,000 to £1,100, then it would seem that the community is entitled to the increment. Well, it receives it, for the time being at any rate, in money; by hypothesis its earnings are £1,100 where formerly they were £1,000, and if consumers desired semi-manufactured goods they could buy this increment. Instead, they will try to buy more consumable goods; and they will fail, for there are not any more to buy yet. But their increased demand will raise the price of those that they can buy, and in this way their reward for enhancing the value of the nation's resources is taken from them.

It is strange that Major Douglas, who undoubtedly desires to distribute this increment of wealth among those who created it, should regard the profiteering by which they are deprived of it as having no bearing on the problem. Certainly the money so filched from its earners remains among the community's income, and we may agree that, taken by itself, the operation described is no more than a piece of injustice which does not affect the running of the economic system. But one cannot take it by itself. It has consequences which from time to time produce a situation wherein a deficiency of money does indeed manifest itself.

The situation thus created is regarded by Major Douglas not merely as a recurring one, but as permanent and growing in intensity, and as arising, not from the causes we have set down, but from the fact that part of the cost of producing any commodity has been incurred prior to the appearance of that commodity in consumable form, spent on commodities produced

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earlier, and cancelled. We must take care to discover exactly what is here meant by a cancellation of credit. (For we are now launched on still another attempt to interpret this theory.) A contraction of credit is, of course, effected by withdrawing credits from individuals ; but there seems to be a suggestion here that the cancellation of individual credits is itself in a peculiar way the root of the trouble, irrespective of whether the total volume of credit suffers a net reduction or not. Since this is certainly the view held by some of Major Douglas's followers, it is worth examination.

The whole volume of industrial credit outstanding at any time is made up of a vast number of smaller credits issued to traders and manufacturers to finance some stage in production or distribution. Any one of these is liable to be cancelled when the particular transaction it finances is completed, though the transaction may not cover the finished production of a consumable commodity. An electrical engineering firm, for example, may borrow from a bank in order to make magnetos. Within three months the magnetos may be made, and sold to a motor manufacturer, whose cheque in settlement is paid in to the bank by the electrical engineer. This money, with the exception of his profit, he owes to the bank, which extinguishes the debt by cancelling the credit. Thus the money that the banker issued to make the magnetos no longer exists.

But the magnetos still exist. For a time they may lie on the shelves of the motor manufacturer. Later they will be fitted to cars, which embody many other components and materials similarly financed by credit

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that has meantime been cancelled. It would therefore be true to say that the particular money distributed in producing these cars no longer exists. But it would not be true to say that the cars in consequence cannot be bought. It would be untrue, because the purchasing power of credit, like that of other forms of money, is not particular but general; and so long as other credit is issued equivalent to that cancelled there is no insufficiency of money. The new credit need not be issued to the same people as the old, nor for the same purposes; so long as it is issued to somebody and for any purpose, it becomes available to buy whatever is then on the market. What matters is the total volume of credit; this must not diminish.

Major Douglas seems at times to perceive the truth of this. Does not his $A + B$ theorem itself refer to "a form of purchasing power," equivalent to the assumed deficiency in the payments made to individuals, as supplementing those payments? In fact, one may read rather extensively in Major Douglas's writings without being quite sure whether he means that there is a deficiency, and one inherent in the system, or that there *would be* one but for the continued creation of bank credit. Certainly he does not support the opinion that the deficiency is a recurring one; and in the end one is left with no doubt that he regards it as constant, not only because he says so, but because his remedy is based on that hypothesis.

For one who believed that the costs of producing a commodity were always and necessarily greater than the money available to buy it would believe also that the costs of production could not possibly be recovered

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in prices, since one cannot charge more for goods than people possess, no matter what they have cost. And if the remedy proposed were one that operated through the regulation of prices, then the price of the commodity would have to be less than its cost. That is exactly what Major Douglas says: the correct price of an article should be a fraction of its cost, and not a very large fraction either. "I am convinced," he writes, "that even now prices are five times too high."¹ He realises, of course, how incredible such a proposition will appear. "At first sight a statement that the correct price of an article may be a low percentage of its cost is apt to induce both disbelief and ridicule."²

Now earlier in this inquiry we also came upon a situation wherein prices were higher than they ought to be. This condition arose during an expansion of credit. But by regarding prices as then too high we meant that they were raised unjustifiably by profiteering, not that they were of necessity higher than the money available to pay them; on the contrary, when this inflation of prices took place more money was about than before; that, in fact, is what permitted them to rise. But this is not at all what Major Douglas means when he speaks of prices being too high; to him the raising of prices by profiteers is a mere "additional factor,"³ if as much as that. "Profiteering," in the sense of charging exorbitant sums in excess of cost, is a mere excrescence on the system. If the producer could be imagined as making no profit at all,

¹ *The Control and Distribution of Production*, p. 73.

² *Ibid.*, p. 79.

³ *Economic Democracy*, p. 62.

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the difficulty would still exist, quite possibly in an exaggerated form." ¹

In other words, profits in Major Douglas's opinion have little or nothing to do with the matter; they are a form of purchasing power; their amount and distribution simply determines which classes in society shall buy that portion of the product that can be bought. This does not mean that in Major Douglas's opinion profits are a matter of indifference to society; he does think, however, that they are irrelevant to the main problem. Add profits to all the other payments made in the course of producing goods and still there is insufficient money to buy goods at their cost of production. That is the Douglas theory; and that is why the Douglas Scheme proposes to assess prices at a fraction of costs and reimburse to the producers; by means of currency notes or other national credit instruments, the difference between the costs they incur and the prices they are allowed to charge. The Douglas Scheme has been presented in more than one form, but the regulation of prices at a fraction of costs is fundamental to them all. What remains to be described is how the fraction is determined. What proportion of the cost of any commodity should be recovered from the consumer in price?

"The answer to this," writes Major Douglas (the reader should not despair if he fails to take it all in at once), "is a statement of the average depreciation of the capital assets of the community, stated in terms of money released over an equal period of time, and the correct price is the money value of this depreciation in

¹ *The Control and Distribution of Production*, p. 79.

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terms of the cost of the article. In other words, the Just Price of an article . . . bears the same ratio to the cost of production that the total consumption and depreciation of the community bears to the total production." ¹

The truth about this price ratio is that it correctly states the just price of consumed goods as a whole compared with the costs of all production, but is not a method of ascertaining the price of a particular article. This, however, is the purpose for which Major Douglas uses it, and therein lies his fundamental fallacy. Let us examine the difference.

To obtain the ratio we must calculate the cost of all we consume (including the plant and so forth we wear out) in a given period, and the cost of all we produce (including both consumable goods and instrumental). If in any given period we simply replace the commodities that we consume and the machinery and so forth that we wear out, production and consumption will be equal, and total prices will rightly equal total costs. But normally we do not merely replace what we consume; we produce more than we consume. The excess for the most part takes the form of new buildings, machinery, and capital goods of various kinds.

Now it would not be fair to expect consumers to pay for more than they consumed. If they consumed three-quarters of what was produced they should pay three-quarters of the cost of all production, and we might express this by saying that the price ratio is three to four. This, of course, is only a way of saying

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that they should pay the costs of what they consume, and so long as we were assured that all the items in those costs—whether called wages, or salaries or profits—were legitimate, then the price charged would be fair. If the producers charged the whole costs of production in the prices of the three-quarters that are consumed the price would be unfair; and that, we know, is what they tend to do. The plan proposed earlier in this book prevents that; but Major Douglas goes further.

In the case described, where three-quarters of total production is consumed, we have said that the price charged should obviously be three-quarters of the cost of all production. No, says the Major; it should be three-quarters of the cost of what is consumed; in other words, the price of every commodity bought for consumption should be three-quarters of its own cost. That is why he finds it necessary to reimburse the producers.

To give a still more concrete example, let us create another small fruitarian island, whose inhabitants live on nothing but coco-nuts. In a given week the cost of all production is 100s. Of this sum 75s., say, is the cost of coco-nuts which are consumed, and 25s. is the cost of planting new coco-nut trees. The price of the coco-nuts may be fixed in either of two ways—excluding for the moment the Douglas way—according to whether prices are socially regulated or not. If they are not, the producers of the coco-nuts will say something like this: "We can sell these nuts for 75s. That price will pay wages, interest charges, directors' fees, and everything else that we usually expect to get

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for our enterprise and skill. The number of nuts happens to be 75, and we can therefore sell them at a shilling each. But there seems to be more money about than that. Let us price the nuts at 1s. 4d. each. That will bring us in 100s., and we shall make an extra profit of 25s." That is what happens nowadays.

We state, on the contrary, that the nuts must be sold for 75s., otherwise people pay for more than they receive. It would not be necessary to reach this figure by calculating the cost of all production and all consumption and expressing the result as a fraction, but if we did, we should say that the price of the coco-nuts should be three-quarters of the cost of all production, and thus reach our 75s., or 1s. per nut. But Major Douglas takes a further step. Having obtained this fraction, he applies it to the cost of producing the coco-nuts. This cost being 75s., three-quarters of it is 56s. 3d.; that, according to the Douglas Scheme, is the just price of the coco-nuts, and 9d. the just price of each nut.

For this reduction I can see no reason. It is not dictated by the necessity to distribute among the community the cost value of the increment of capital wealth. That object has already been secured by leaving in the consumers' hands the difference between the cost of what they have consumed and what they have produced, namely, 25s. in our example. That is the value in money of the new capital. But the Douglas Scheme in the circumstances supposed would leave with the consumers not merely this 25s., but an additional 18s. 9d. This seems to me quite unsound, and one is almost tempted to believe that Major

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Douglas has not properly understood the implications of his own discoveries.

The flaw in his scheme, however, does not diminish the value of Major Douglas's disclosure that, whereas a certain relation must exist between the flow of prices and the flow of purchasing power, our monetary system does not ensure that the proper relation shall always be preserved, and that the only way to preserve it is to bring the prices of commodities under public control.

The arguments for the control of prices put forward in this book are in no way weakened by the suspension of the gold standard. That wise but belated act will afford little help to our industries unless it is accompanied by an expansion of credit. If the expansion is allowed to raise the level of prices, imports will be encouraged and exports discouraged. The result will eventually be a renewed depreciation of sterling, in consequence of which, either we shall pay more and more for our essential imports, or credit must again be restricted and depression ensue. But these evils can be avoided. Conditions have never been more favourable than they are now for the wise use of credit and the establishment of the just price.

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Yet Mr. Robertson, for example, besides knowing Lewis Carroll by heart and having an apt quotation

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therefrom for every economic situation, can be something of a visionary, and referred recently to the problem of "groping our way towards the conversion of the old bad expedient of under-employment into the new remedy of redistribution of leisure." And Mr. Keynes, who is liable to say anything at any time, and derides the most respectable theories when they bore him, has often been a valiant opponent of official policy.

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A selection of the books by some of those writers who, though their theories are by no means alike, call themselves or are called the New Economists. Mr. Arthur Kitson was a pioneer among those who saw the inconvenience of a Gold Standard to modern communities.

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