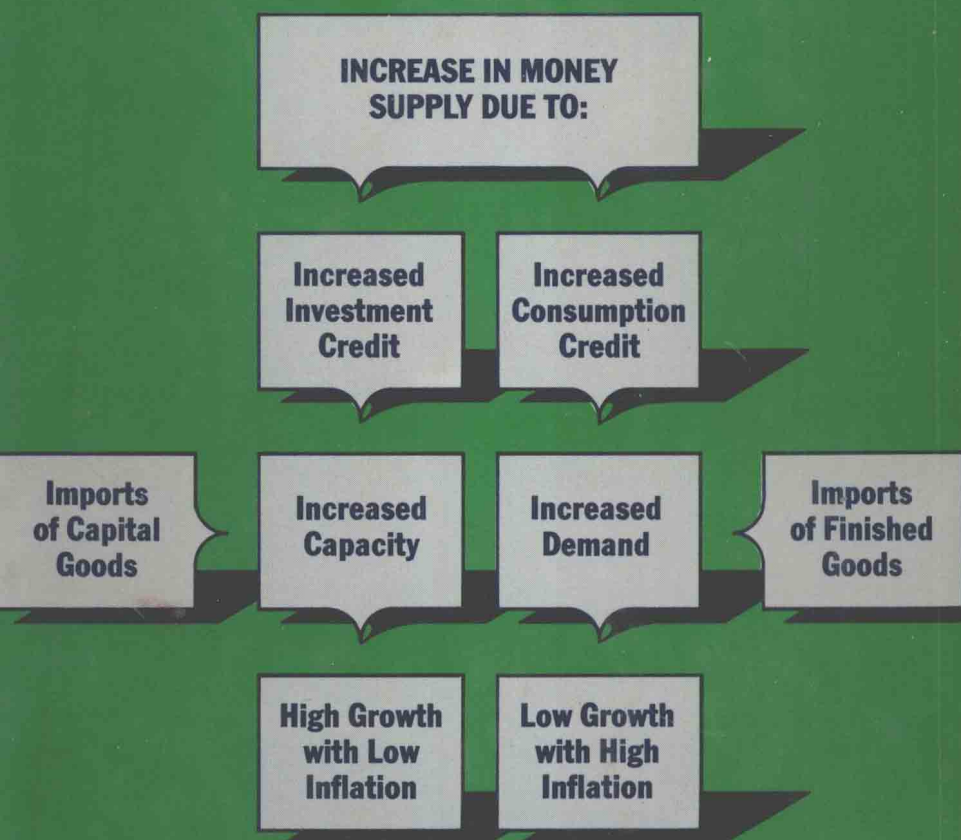


How Economic Growth and Inflation Happen

George T. Edwards



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Preface and Acknowledgements

For over twenty years I have been fascinated – some observers might fairly say obsessed – by the way that money acts through the credit system of economies with varying effects on growth and inflation. My reading and research have increasingly led me to take the view that there are several erroneous ideas in economic theory as it is currently taught. Furthermore, there are several ideas which to me seem to be valid and these are not usually taught at all. This book describes a theoretical economic system which rests not upon abstractions but is derived from observation.

Any book so based is bound to be a little untidy. Reality always has sufficient complexity to make a mockery of most systems of abstraction. Nonetheless, some theoretical principles are more valid, that is, more important in a chain of predictable causation, than others. For example, Keynes took the view that the demand for investment capital by industry was a function of the interest rate. Low interest rates, in his theory, would cause increased demand from business for investment money, if everything else was held equal. That is indeed part of the story, but I believe there is a more valid proposition.

The demand for industrial investment capital in my economics depends on the expected repayment rate – that is, upon the proportion of the loan repayable every year. Businesses invest more by borrowing more when repayment rates fall, usually due to the lengthening of loan terms, and while the interest rate is not irrelevant, the repayment rate is crucial. Low repayment rates improve business confidence by improving companies' liquidity (that is, by providing additional excess cash-flow above project costs); high repayment rates worsen business confidence by reducing companies' liquidity.

The great simplifier Milton Friedman has claimed that inflation is

'always and everywhere' due to governments printing money. Apart from that partial truth – invariably elevated in monetarist economics into all the law – monetarist economics largely consists of a blind faith in the free market forces. Yet it is a matter of commonplace observation that money markets are actually regulated everywhere; and who would wish to conquer inflation at the price of greater misery?

In retrospect Keynesian economics was an economics of full employment at the price of higher inflation. Nonetheless it gave the world three decades of unprecedented prosperity. Monetarist economics is about controlling the inflation rate; it has nothing but pious platitudes about how to produce prosperity, and so far monetarism has threatened, in some developed countries, to turn a recession into a great depression. So far, monetarism has given us a decade of increasing misery and higher unemployment. Of both Keynesianism and monetarism it can be said 'Even if they were completely valid within their own self-set limitation, they would not be enough.'

There is a need, in my opinion, for an economics of prosperity, for a set of simplified (but not simple) guidelines about how some economies succeed in producing not-so-inflationary growth. This book is my contribution to that objective.

Thanks are due to the brilliant Lord Lever, who understands this new economics and appreciates the need for it; to John Carrington, without whose previous help this book would not have been written; to Sir Ian Gilmour, whose excellent book *Britain Can Work* inspired me to complete this book; and to Dr Yao-Su Hu, who kindly read the manuscript and offered several valuable suggestions and great encouragement.

Thanks are also due to Macmillan, my publishers, who waited patiently for several years; and to those many fine sources of national statistics, the Central Statistical Office of the UK; Eurostat of the Common Market; the Bureau of Statistics, Office of the Prime Minister, Tokyo; the Office of the President, USA; the Statistical Office of the United Nations; and of course the OECD in Paris.

GEORGE T. EDWARDS

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1 Introduction, Purpose and Plan of the Book

1.1 INTRODUCTION

This book has arisen naturally as the result of over ten years' research into the reasons for the observed rates of economic growth and inflation in five countries, as revealed by a deep study of their financial systems. At present, when Anglo-Saxon economies throughout the world have failed to match the growth of most other developed Western countries, it is often possible to find sociological arguments relating to the relative economic decline of English-speaking countries. Yet the reasons for economic failure are perhaps best sought in economic factors, rather than the burden of explanation being thrown upon the shoulders of sociologists, who are, as Hobsbawm has remarked, 'even less capable of bearing it, but just as willing to try'.¹

It may be as well to begin by outlining some of the evidence which indicates the relative economic failure of manufacturing industry in the Anglo-Saxon economies (by which I mean the United States of America, the United Kingdom, Australia, Canada and New Zealand). If developed Western countries are ranked by order of their annual rate of productivity improvement in manufacturing industry for the eleven years 1966 – 77, then the lowest rate of growth, at 2.2 per cent per annum is that of the USA. Table 1.1 shows these average rates of productivity improvement for a group of ten countries.

There is an Anglo-Saxon group of low-productivity countries clustered at the bottom of the table – Canada, the UK and USA are all notable for their poor productivity performance. Australia and New Zealand, though unlisted here, also have low rates of growth of

TABLE 1.1 *Average annual rate of improvement in manpower productivity in all manufacturing industries in twelve countries, 1966-77*

Country	Average annual rate (percentages)
Japan	8.6
Belgium	7.8
Holland	7.2
West Germany	5.6
France	5.6
Italy	4.9
Sweden	4.9
Canada	3.5
UK	2.6
USA	2.2

SOURCE US Department of Labor.

manpower productivity in manufacturing. Located above the low-productivity Anglo-Saxon group of nations were virtually all major nations of Western Europe – Sweden and Italy at 4.9 per cent, France and West Germany at 5.6 per cent, Holland at 7.2 per cent, and Belgium at 7.8 per cent. Japan was at the top of the table; its manufacturing productivity improved during the 1966 – 77 period by 8.6 per cent. This period produces results which are by no means untypical. Any period of half a dozen years since 1950 would produce broadly similar results. Low productivity growth in manufacturing industry is an Anglo-Saxon problem, and is not confined to Britain alone.

The reasons for high growth in Japan and low growth in the UK can be determined by even a cursory examination of the functions of their respective financial systems. Virtually every financial institution in Japan collects savings and advances most of it directly or indirectly to industry as long-term investment credit; virtually no financial institution in the UK collects public savings with a view to providing industry with long-term investment credit. Japanese monetary policies stimulate investment credit, investment and industrial supply; British government policies act at best by ‘managing demand’. At its crudest, the question can be asked: how much saving is being canalised to investment, initially to fuel expansion?

Of course, some bankers might maintain that the structure of

financial systems makes no difference, since market forces may be deciding between industry and the consumer on the basis of willingness to pay particular repayment and interest rates, but this begs the question of the usual function of the banking system, which differs considerably from country to country. Other bankers may allege that national financial systems have developed differently to meet different needs, and other non-financial factors could be responsible for holding Britain back.

The idea that the provision of investment credit confers no advantage to industry seems, however, a very difficult argument to maintain. There are no known cases where industrial companies have succeeded in expanding their operations without access to financial resources. The cheap, long-term investment credit available to Japanese businessmen makes a difference only to the extent that money for expansion makes a difference – and the evidence indicates that this difference is significant. There may, however, be little agreement on the relationships between the nature and structure of the financial institutions of a country, and that country's economic performance, because there seems to be a gap in economic literature – very few books deal with the subject. This book is intended to help fill that gap.

Some of the evidence for several of the propositions put forward in this book can be found in two previous books, which were co-authored by John Carrington, entitled *Financing Industrial Investment*² and *Reversing Economic Decline*.³ This book, however, does not simply re-state previous hypotheses but extends and adds to these propositions in order to provide a more complete economic model of a country's financial economic system. The basic bias in this book is towards a practical understanding of economic forces, construed and constructed according to the evidence available in the national accounting systems.

Five economies – France, Japan, West Germany, the UK and the USA – will be repeatedly used as touchstones throughout this book. These economies comprise about three-quarters of the industrial capacity of the developed market economies of the world. The reason for the selection of these countries is that they provide a wide range of differences in their financial institutions and their economic results. France has a largely nationalised, centrally controlled system of financial institutions, which act in concert to provide public service and industrial funds to attain the objectives specified in the national economic planning targets produced by the Commissariat du Plan.

Japan has a dirigiste system of private banking, involving hundreds of institutions which are often integrated with the industrial grouping to which they lend. West Germany has a largely private banking system which exercises discretionary but reluctantly used vast power over a private industry which is dependent on the banks for investment loans. UK and USA banks largely provide only short-term capital to industry, which is expected to raise its long-term capital needs via the stock markets or merchant banks.

Although some parts of the national accounts statistics of these five countries will be continually cited in this book, it is necessary to remember the systematic and random errors to which all systems of national accounting are subject. In general, differences in the major economic results – in investment levels, growth and inflation rates – are generally sufficiently variable to leave little doubt about the significance of the differences, but where minor flows of finance are cited, the room for error is obviously larger, and caution in interpretation is advisable.

It will be my contention throughout this book that there has been a failure of economic understanding in Anglo-Saxon economies – a failure to appreciate the linkages between the flows of funds provided by credit institutions and the results in the real economy in terms of growth and inflation. This failure is the more surprising, because monetary theories relating money supply to inflation rates are in a fashionable ascendancy, perhaps primarily due to the writing of Milton Friedman and the Chicago School. These theories are interesting but have perhaps a rather broad-brush and indiscriminate approach to the problem. When Friedman argues that the increases in the money supply by governments are ‘everywhere and always’ at the root of the inflationary process, he ignores the possibility that these increases in money supply may also be at the root of the process of economic growth. For example, Japan’s monetary authorities (by diverse and subtle means) have pursued an expansionary monetary policy since the end of the Second World War. During the 1960s, money supply in Japan usually increased by about 15 per cent per annum, and this resulted in more growth than inflation during that period. On the other hand, successive British governments have sought (increasingly unsuccessfully during the 1950s and 1960s) to control inflation and maintain the value of the pound by periodic credit squeezes and, except for the period 1970–3, by a low rate of expansion in money supply, and this produced a low growth and a rising cyclical trend rate of inflation. Or, to take another example of

contrasts, Brazil has had very high inflation and high growth; Chile has had very high inflation and low growth. Monetary policies may sometimes be identical, if measured by the percentage increase in money supply, yet economic growth rates and social results can be vastly different. Any theory which ignores the growth rate, assuming it to be given by underlying trend forces, ignores the problem posed and the challenge involved in attempting to understand how economic growth and inflation happen.

1.2 PURPOSE OF THE BOOK

The primary purpose of this book is to outline the relationships between the flows of funds in the financial system of a country with the out-turn results in the 'real economy' in terms of the observed economic growth and inflation rates. A secondary purpose is to propose a single economic model, based upon an examination of the national accounting systems, which explains the economic decline of the UK, the USA and Anglo-Saxon countries as well as the economic ascent of France, Japan and West Germany, in terms of existing or slightly modified economic theory.

Yet although this book will outline a theoretical model of how economic growth and inflation occur as natural consequences of the interaction of the credit system with the real economy, the basic bias of the book is not theoretical but intensely practical. The theory is largely derived from an examination of those occasionally inadequate but indispensable guideposts, the data in the national accounting systems. The touchstone is the objective reality as best it can be enumerated.

No competent book on economics, however, can be entirely original. So much research has already been done on the subjects of economic growth and inflation that this current book is partly a drawing together of existing data, with some limited original observations, to form a coherent whole, with due acknowledgement to sources.

The justification for this activity is surely manifest at present. As I write, high inflation, low growth and unemployment haunt the developed economies, while large-scale unemployment, poverty and stagnation – and occasionally starvation – are visited on many third world economies. A better economic understanding will not wholly remove such problems, but it may help ameliorate them.

For the ultimate purpose of this book lies beyond the book, in an improvement in economic understanding and an increase in the co-operative capability of the workforce, businessmen and politicians of countries in determining a better future for themselves and their children.

1.3 PLAN OF THE BOOK

If the structure of this book had to be summed up in a paragraph, it could be said that Chapter 2 proposes an economic model relating financial flows to growth and inflation rates; Chapter 3 illustrates the model by reference to five economies; Chapter 4 outlines some policy applications of the model (in reversing economic decline, integrating Western European economies, and helping third world development) and Chapter 5 proposes conclusions.

Chapter 2 outlines a proposed economic model in some detail. Evidence for some economic hypotheses is not always fully laid out in this chapter, especially when the hypothesis is derived from data and argument which is more completely displayed in previous books. Chapter 2 begins (in section 2.1) by making several introductory comments which indicate the scope and nature of the proposed economic model. Principal among these observations are the limitations that, first, the model covers only the major economic sectors of households, industry and government; second, that the model rests upon an appeal to statistical evidence when issues and arguments are in doubt, and hence does not rely upon an exhaustive list of abstract assumptions (this is not always an advantage, for conclusions reached can only be as valid or as doubtful as the comparability of the data); and third, no quantitative explanations are offered for the investment levels of the personal sector and government. The model is therefore a first approximation which seeks to relate major variables – how financial saving (largely generated by households) and circulating credit may be transferred as loans, partly to households and government but especially to industry, which generates that investment which largely determines the growth rate of an economy. This broad-brush approach will undoubtedly have its critics, but my objectives would be more than met if major factors can be correctly interrelated in the first instance. Additional complexities, overlaying the basic framework, could possibly follow later.

Section 2.2 discusses some of the factors affecting the supply of