REVERSING ECONOMIC DECLINE

John C. Carrington
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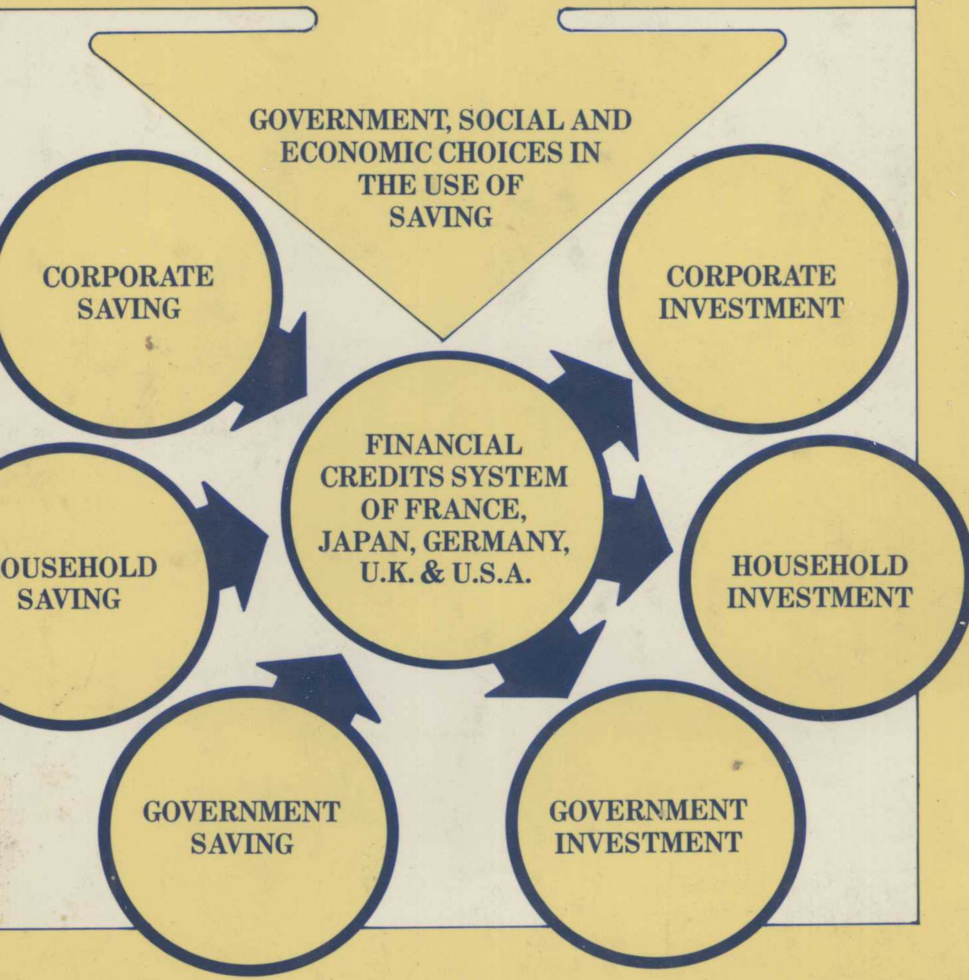

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Preface

In the English-speaking countries – in Australia, Canada, New Zealand, the United Kingdom and the United States of America – industrial productivity has advanced but slowly in the last thirty years. During the same period, industrial productivity has increased dramatically in the market economies of Western Europe and Japan. The result has been a relative economic decline of the English-speaking countries.

This book addresses itself to the central reasons for that economic decline, and proposes policies aimed at reversing that decline. The economic failure has been the natural consequence of a failure in understanding. At present, most economists are Keynesian, but most official economic policies are monetarist, aimed at reducing inflation via money supply restrictions.

A Keynesian would argue that an increase in money supply lowers interest rates, increases investment (because more investments are profitable) and thereby produces higher growth and employment. A monetarist would argue that, on some national evidence, an increase in money supply increases consumption demand and largely produces inflation.

We should like to point out that the real outcome depends on circumstances – for if the financial system of a country canalises much of the increase in money supply to investment (as in Japan) then the Keynesians are the more correct, whereas if the financial system principally funds short-term consumption (as in the UK) then the monetarists are the more correct. Hence, it is possible to construct an economic theory within which Keynesian and monetarist viewpoints are but two extreme and special cases.

This study (which has been derived from an examination of the economic realities in five countries) clearly indicates that if the English-speaking economies wish to reverse their economic decline some restructuring of their investment-funding systems is required.

We are grateful for the critical and helpful comments, discussions and correspondence on this subject with friends, colleagues,

economists, bankers, businessmen and students, without which this book would not have been possible. Responsibility for the opinions and possible errors in this book is, of course, ours alone.

The authors and publishers wish to thank the Controller of Her Majesty's Stationery Office for permission to quote from *Economic Trends 1976*, *Financial Statistics April 1978* and extracts from the text of other HMSO publications, and all of the other authors, publishers and authorities who are individually mentioned in the notes and in the footnotes to the tables.

May 1980 JCC GTE

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1 Purpose and Plan of this Book

1.1 INTRODUCTORY COMMENTS AND PURPOSE OF THE BOOK

A great deal of modern economics is theoretical. Theories are all very well, but if theory is to be useful as a guide to practice, then a comparison needs to be made, from time to time, between the predictions of the theories and the touchstone of the objective reality. This is the more important because, as Keynes pointed out, 'Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.'[1]

It is therefore ironic that the defunct economist who has the most effect on the minds of practical men is none other than Keynes himself; for the impact of Keynesian economics has been so strong that economists and governments have gone on applying the Keynesian solution (to a demand-deficiency in the 1930s) during the 1950s and the 1960s when there was no deficiency of demand in the economy, but precisely the converse – as inflation rates have testified.

Another economist, Sumner Rosen, has put this point by saying,

> Economists have spent the last thirty years bringing to fruition what we might call, to use Lawrence Klein's phrase, the 'Keynesian Revolution'. The process has three important aspects. One is that the revolution turned out to be less extensive than its enthusiasts claim. Unemployment had not been solved; steady growth in response to the right fiscal and monetary stimuli had not been achieved; inflation has remained a periodic threat. A second is that the revolution pre-empted nearly all the professional energies available and dominated the development of economic studies – and of economists – throughout most of this period. A third aspect is that its apparent triumph, however

> important – and it *is* important – has tended to cultivate among economists and their public a complacency about the adequacy of our arsenal of policies for dealing with economic problems. But urgent problems exist about which Keynes and Keynesianism has little to tell us. The result is a disturbing vacuum.[2]

If there has been complacency about the apparent Keynesian 'solving' of the unemployment problem, then there is much less complacency at present, when unemployment has risen considerably, in most developed Western economies, above the low levels it attained in the 1950s. The problem of steady, preferably rapid, economic growth had not been solved in those nations which had embraced Keynesian economics first – the USA and the UK. And Keynesian economics, while it indicated how to deal with a deficiency of demand, had no programmes aimed at coping with a deficiency of supply – Keynesian economics, as many have observed, has little to say about how to increase economic growth. It is our intention that this book may help fill at least part of that vacuum in policy to which Sumner Rosen refers.

In a previous book,[3] we have examined the procedures used for financing industrial investment in France, Japan, West Germany, the UK and the USA, and in doing so we suggested how the financing of industrial investment might be improved in the UK and in other English-speaking countries. This book takes that procedure one step further by pointing out some propositions which are testable and which could form part of an explicit economic model which may partially help to bridge the gap between theoretical macro-economics and practice; or, to be more precise, the purpose of this book is to discuss the factors which affect the level and nature (or type) of the major national economic variables (such as the factors affecting the level and kinds of saving, investment and consumption by individuals, companies and government) and, after so doing, to propose from observation a new descriptive model of the national financial system which may enable the realistic if approximate evaluation of real-world economic situations and thereby to suggest solutions to economic problems at the level of the national economy.

This book, like its predecessor, is heavily biased toward the analysis of national income statistics to illustrate and explain theoretical points. The limitations in these statistics – the errors inherent in any economic sampling, classifying or estimating –

should be borne in mind continuously, for many national estimates of the levels of aggregated activities (such as the saving or investment level) can easily be in error by several per cent.[4] It is necessary constantly to remember these data limitations, while realising they will not be generally so unreliable as to overturn the results of most calculations.

The economic statistics we will regularly use for the purposes of comparison and illustration will be those of France, Japan, West Germany, the UK and the USA. These five countries represent, in our opinion, a fair mixture of the economic diversity possible to the nations of the West; an interesting case of economic renewal (France); the largest rapidly growing economy in the world (Japan); a prosperous industrial and growing economy (West Germany); a slowly growing economy with intransigent economic problems (the UK); and a slowly growing economy that is at the same time the largest in the world (the USA). These economies will often be called the 'five countries' or the 'five nations' in tables and in text.

An outline summary of the contents of this book follows in the next section, but a brief encapsulation of the chapters seems justified here. This book continues with an examination of the factors which may affect the volume and nature of savings by households, industry and government (Chapter 2); the social and economic choices facing governments and societies in the use of these limited savings for house purchase or consumer credit by individuals, investment credit for productive investment by industry, or government borrowing for investment in social overhead capital, are discussed in Chapter 3; the factors which may determine the volumes of household, industrial and government investment, the effect on individual living standards of the scale of production, and the quality of the social infrastructure are outlined in Chapter 4; the possible inter-relationships between price-profiles and consumption levels in an economy are mentioned and a preferred relationship between the interest rate, the inflation rate and the cost of borrowing is proposed in Chapter 5; some aspects of the role of financial institutions in the economy are discussed in Chapter 6; and, finally, a short programme for the reversal of the UK's economic decline is suggested in Chapter 7.

The aim of this book is essentially pragmatic – to outline a procedure for the reversal of the relative economic decline of a country, basing that procedure upon observations derived from national income data – and, if there are errors in our approach, it is to be hoped that further research may correct these.

1.2 GUIDE TO CHAPTERS 2–7

The purpose of Chapter 2 is to deal with the factors affecting the level and type of financial savings made by individuals, industry and government. In Chapter 2 we are not concerned with the net saving or borrowing of an economic sector (or that sector's saving minus its borrowing) but with the total flow of funds which each sector contributes to the financial system.

Section 2.1 briefly illustrates the way in which funds flow through the financial system from saver to borrower, using Eurostat data of flows of funds in the UK in 1970 as an example.

Section 2.2 discusses the level and type of household savings in France, Japan, West Germany, the UK and the USA, highlighting some individual characteristics of each. Section 2.3 is a comparative analysis of household saving and discusses possible reasons for differences in the savings level and type in the five countries.

The financial savings generated by households (or the personal sector, or individuals, as the private non-business sector is variously defined) are dealt with in some detail in Chapter 2 compared with the less thorough discussion of the factors affecting the savings of enterprises (Section 2.4), government financial savings (Section 2.5) or the savings of the rest of the world (Section 2.6). There are two principal reasons for this emphasis on household saving: first, households generate most of the uncommitted transferable saving in an economy, and, second, household saving seems more amenable to analysis and exhibits more explicable behaviour than the saving of other sectors.

Section 2.7 acts as a summary of Chapter 2 and points out that the relevance of saving resources, in the context of reversing economic decline, lies in the capability of some financial saving to be canalised through financial intermediaries to investment credits.

The purpose of Chapter 3 is to outline the social and economic choices faced by governments and society in transferring saving into particular kinds of lending. Chapter 3 points out that saving can be utilised for five distinct purposes: for consumer credit, for government borrowing, for industrial investment credit, for financial investment, or for adding to the liquidity of the banking system.

Section 3.1 discusses the economic effects arising from these choices and their implications for the level of demand, the amount of social overhead capital, and productivity. The balanced use of saving resources is discussed in Section 3.2, where contrasts are drawn between advancing funds at home or abroad, between consumer credit and investment credit, between the level of private living standards and social amenity, and between government investment and private investment. The choice, at one level, can be represented by the clash between the public standard of life and the private standard of living. Public living standards are often defined in terms of amenity, in terms of the quality of the shared social infrastructure – the social overhead capital of roads, hospitals, schools, public buildings, and the design of city centres. The private standard of living experienced by individuals, in terms of their consumption of goods and services, is largely determined by their productivity, which is in turn affected by the degree of machine investment.

The uses of scarce savings for investment as social overhead capital, financial investment (or consumption) or in productive industry depends upon the desired balance between the public living standards, the level of demand and the standard of living. It is proposed that a simultaneous advance in industrial productivity, private living standards and social amenity is a preferred policy to the imbalanced capital development of purely one sector. Section 3.3 indicates the actual allocation of savings resources to the economic sectors in the five countries, and briefly discusses the apparent order of priorities in each country. In Section 3.4 some social consequences of economic choices are pointed out, in terms of a capital stock comparison, housing standards, nominal and real living standards, and other indicators of living standards (car, telephone and TV diffusion rates; the relative number of doctors available; infant mortality rates; hospital bed availability; and expectations of life at birth). Section 3.5 proposes some conclusions pointing out the momentum of historical factors, which may produce results which are not consequences of choice; and several observations about the present economic situation of each nation and its economic history are offered.

Chapter 4 outlines the mechanisms which determine the level of investment by households, industry and government. Section 4.1