CHAPTER 4

MONEY AND THE STATE

Modern industrial society can only run on money. The Russians found that out. Not even Communism can run a modern industrial system without money. A system reposing on exchange of goods and services for goods and services—barter—would be hopelessly slow, cumbrous and costly. 'Money is what money does.' What it does is measure the relative costs, selling prices, and values of all economic activities one against another: just as inches, pints or ounces measure the lengths, volumes or weights of things. But whereas these ordinary measures never vary because if they did nobody could be sure of anything, money units—shillings, marks, dollars—themselves vary in extraordinary ways.

An inch, a pint, an ounce is only an abstract idea. It only becomes a fact when attached to cloth, liquids, or solids. But a dollar, a pound sterling, a franc is not only an abstract idea. It is already a value: a 'value in exchange' in itself, a piece of 'purchasing power', a 'unit of currency', legal tender in any transaction for just so much of anything else. Trouble in people's thinking, and in public affairs, arises because all modern money includes credit: *i.e.* not only coin, banknotes, and cheques drawn on banks, but also *permits* from lenders to borrowers which give the latter *more* 'purchasing power'. A bank giving such a permit to a client to overdraw—to draw cheques (money) to buy more things over and above his stock of money at the time—is increasing the supply of money and credit (unless some former borrower at that moment is repaying a former credit of that amount somewhere). So is a trader who grants a customer a longer period of 'tick' in which to repay a trade debt. So is a government which, by borrowing from the banks, is spending more than its tax or

other revenue and more than the proceeds of its sales of bonds to investors (for their savings). The more such credit is created on balance (*i.e.* over and above repayments of former credits) the more ordinary money will also be needed to do the extra work: more coin, banknotes, cheques, etc.

So if the total supply of *money and credit* in any period is expanding at a faster rate than the total supply of things to spend it on, there will be more and more monetary units of measure. The units of monetary measure will each diminish in purchasing power over goods. They will be getting smaller, as if inches were reduced to half-inches. Double the number of half-inches measures the same length of timber as a number of inches. The length of timber is the same. So, too, doubling the flow of money and credit in any period, while merely maintaining the supply of things to spend it on in the markets, will simply send holders of twice the amount of purchasing power into those markets to buy the same available things. More of some things will be wanted, the same amounts of others; more luxuries, hardly any more bread. But supplies of things are the same; so some things' prices will more than double, some prices won't rise much, some perhaps not at all. Yet the general, average, price level will be broadly double what it was as the doubled supply of money and credit goes round on offer, doing its buying work. And the whole pattern of production will be convulsed as more money bids more of certain things into production, out of *limited* resources.

Present and Future Things

If, as in primitive societies, only immediately consumable things (like simple food) were produced and placed on offer in markets, the problems of inflation would not be so complex. But modern industrial society is a form of social organization at which all the world for the first time in history is striving to arrive as fast as possible. And in industrialized societies more and more production, more employment, more machinery and buildings are *not* for immediately consumable things. They are for capital goods: things in durable use by consumers (houses, cars, home equipment, other gadgets) and by producers (factories, ports, railways, highways, mines, machines of all kinds, tools). To produce all this capital equipment for producers and consumers alike takes much time, many skills, specialization, and a lot of different

kinds of manpower and machine-power. They are all in very limited supply, expandable only slowly.

Capital equipment *is* industrialism, in Russia as in America. Industrialization is the building-up and working of capital equipment. It is all the invested, frozen, congealed savings of some people somewhere, who have not spent all the money and credit they had available at the moment on immediately consumable things. Their savings—freely made in a democracy, either individually or collectively in the shape of business profits or insurance premiums—are invested in the equipment and production of *things for future uses*. To get a lot more savings very suddenly is difficult. Suddenly to boost monetary demand for those capital things by inflating is dangerous, for the savings and resources out of which they are made are limited. Their prices will rise formidably, and so therefore will demand for all these ingredients (including, of course, skilled labour). Employment of all resources will also therefore tend to become full, and if inflation persists over-full.

This distinction between immediately consumable things and things with uses in the future is crucial. It is mainly a difference between income and capital, spending and saving, present uses and future uses, work for present consumption and work for future uses and consumption. Industrialism, which is capitalism, depends on a balance between present spending and saving for the future. Its growth depends on a balance between *saving* out of presently available money and credit and *investing* that saving in things to be produced for future use. The economic growth of any society depends on how much of somebody's immediate purchasing power (money and credit) can be saved and invested in the increasing new forms of capital equipment, to expand output of all wanted things (whether for consumers or producers) in the future.

The investment of savings buys time. They finance the time, managerial and other human skills and know-how, the materials, fuel and power, transport, building space, and all other ingredients needed to make any tool or piece of capital equipment. The Stone Age cave-dwellers who kept a skilled flint-knapper and his family in meat and skins and cave-room to furnish the best weapons for the chase were saving immediately available meat and skins and cave-room and investing them in a tools

factory and in the payment of wages to its skilled labour. They were increasing their own hunting efficiency, *i.e.* their standard of living, by investment in new and better capital equipment. They were financing (investing savings in) time, know-how, capital (a factory) and labour for future improvements.

Now if a democratic society needs new tools and productive capital equipment, it must make it worth some savers' while—*all* the while, all the time required to make them—not to spend immediately available purchasing power (whether the latter is money and credit or mammoth-tusks) merely for immediate consumption. This buying of time and the buying of present resources of all kinds, to convert them into new things with future uses, is investment. Borrowing savings, investing someone's present purchasing power in a conversion job over a period of time, has its cost—which is the rate of interest paid to the saver. The borrower pays interest for the time during which he borrows another's purchasing power. Interest is calculated at so many units per hundred units borrowed, per year of the loan: 6 per cent per annum = £6 or $6 every year per £100 or $100 of someone else's money and credit. The interest rate rises the longer the time, for in a longer time risks increase, and other opportunities to spend which the lender could have taken will have to be given up by him. If the borrower succeeds in his capital-employing, and perhaps capital-producing, venture, he will make a *profit* (over and above all costs, including the interest he pays) out of which he will pay himself a 'dividend on enterprise': the reward for his own risk of losing everything. He will also, if profits are big enough, 'plough back' some into the venture and so provide it with new capital out of its own new savings, either for use or to repay the original capital sum which was borrowed. In either case ploughed-back profits are new savings.

Time—present and future, spending or saving, long and short-term—is at the heart of saving and investment, at the heart of all building-up of capital, and therefore at the heart of capitalistic industrialism and industrial capitalism (whether Russian or American).

Inflation, Investment and Profits

Accordingly it is imperative that units of purchasing power saved and invested at present prices should yield interest, as the

time of the loan or investment rolls by, at exactly the fixed annual rate calculated by lenders and borrowers when they contracted, and in units of the same purchasing power.

But inflation multiplies the units of purchasing power more than the things they are spent on. Inflation therefore makes all money costs and prices go up during the life of the loan or investment. So if the lender agreed in 1960 to invest £100 of savings for ten years at 6 per cent and by 1970 the price level had doubled, he would get back his *nominal* or *face-value* capital of £100 by 1970; but it would only buy what £50 bought in 1960. He would have lost one-half of his *real* capital: one-half of its original purchasing power over real goods. Worse, he would not even have received in the ten years the *real* 6 per cent he had bargained for. Only the £6 interest received for that first year by the end of 1960 would have had the full 1960 purchasing power. In 1961, 1962, 1963 and so on till the end of 1969, each year's *fixed* interest of £6 on the £100 of capital invested would buy less than the first £6 received in 1960. And the last £6 of interest received in 1969 would only buy one-half of the things which the first £6 had bought a decade earlier.

So the borrower would get £100 worth of *real capital* (*i.e.* things, resources, goods and services) from the saver or lender in 1960. But instead of paying a *real* 6 per cent rate of interest each year for ten years on this original loan of 1960's purchasing power, he would be paying a lower and lower *real* rate of interest year after year, as money and credit are inflated and the prices of things rise. And at the end of 1969 and of the term of the fixed-interest loan, he would be able to repay the original saver and lender with half the purchasing power of the original loan, half the amount of 1960 goods and services. That is why inflation always works against long-term lending at fixed interest, and in favour of 'equities' which must 'share' in the rising inflationary profits from rising prices.

Meanwhile the borrower would have at once converted the loan in 1960 into *real* resources—wages, materials, factory space, fuel and power, etc.—and used these over and over again in the ten years. He would have been buying them and converting them into end-products easily sold at rising prices because of the inflation. So the borrower would be buying-in his resources at one price level, converting them, and selling the products later on

at a slightly higher level, thus making not only a normal profit but also a continuous inflationary profit, a 'windfall profit', an uncovenanted benefit in extra money-receipts over money-costs.

Moreover, this is a profit element bearing no relation to the efficiency of the enterprise. It comes from without, from inflation of the customers' purchasing power. That is why inflation always works in favour of ordinary, risk-bearing, equity shares, risk capital. The investor of savings in such equity capital enjoys the protection of a built-in 'hedge' against inflation, as long as the inflating government does not tax away *all* those inflationary profits. Either the businessman-borrower—company, farmer, offerer of services, trader—can go on making inflationary profits easily year by year, or he can sell out his business to others who by then will want to acquire a 'hedge' against the inflation. In the latter case he will of course make a capital profit which (at least in many countries, including Britain) is not taxable. He will have sold a business valued at, say, £1,000 in 1960 for £1,500 or even £2,000 by 1965 or so.

This capital value of the business will in fact tend to rise *faster* than the rate at which the money loses its purchasing power. For everybody will soon be aware of the dangers of fixed-interest investments in the inflation. They will be vying with each other to buy businesses, equity shares, land or real estate, even antiques, old masters and even young masters, or anything else offering a built-in 'hedge' against the continuous rise in the price level, because its price is likely to rise with that level. The supply of such investments is always limited. It will become more strictly limited, and the prices of such investments will soar disproportionately higher, as everyone bids for the relatively few coming on to the various investment and capital markets.

Thus inflation brings uncovenanted profits and capital gains which bear little relation to efficiency, competitiveness, or technical progress. On the contrary, it tends to keep in existence—in a spuriously profitable existence—enterprises (private or State-owned) which in the course of technical progress, of economical use of savings and other resources, and of competitive efficiency to achieve more rapid economic growth, would have gone out of production. The resources they still use would have been more profitably used for everyone—workers, producers, consumers, the

State—in other ways, had not the inflationary veil been cast over their real costs of operation.

Time and Value

Time is of the essence of the inflation problem. When the government of a modern industrial, and therefore highly complex, society deliberately depreciates the purchasing power of its currency as it goes along—or lazily acquiesces in its loss of purchasing power by allowing the supply of it to expand faster than national production and productivity—the units of measurement for all values will not only depreciate. They will depreciate more and more through time. They will have greater purchasing power over the bulk of immediately purchasable consumers' goods and services coming on to markets, but less over the smaller (but crucial, more costly, and much longer-to-make) supply of capital goods required for the future. Money now and real goods now will be worth more than money to come or property to come.

Prices will rise, but not all to the same extent or in the same degree. According to the degree or rate of inflation, all investment will be diverted first from low to high fixed-interest at long-term, then from long-term fixed-interest to short-term fixed-interest or wholly risk-bearing investment (equity investment), and finally away from investment in future production altogether. If inflation becomes breakneck, no one will save or invest in normal production for the future. People will not hold money. They will spend frantically, to get real goods. Goods will become measures of value themselves, one being valued in terms of another in the primitive exchange system of barter, as society's monetary measure breaks down. Society will revert to a pre-credit, pre-monetary stage, which will render capitalistic and industrial production, banking, credit and trade impossible.

The governor and pivot of the capitalistic, industrial system is thus reliability of the measure of values through a reasonable time to come. It is the dependability of the currency as a measure and medium for the ever-increasing and more complicated exchanges and transactions in industrial society. These are not only between buyers and sellers of things in the present, but to an increasing extent also between present purchasing power (savings) and future purchasing power (future yields on investment).

Of course, the *real* values always remain, whether in American

or in Russian society: the tons of this, freight-miles of that, gallons, yards, man-hours of work, machine-hours of work, cubic feet of work-space in buildings, kilowatts or gallons of fuel and power, and so on. These are all ingredients of one thing or another produced, offered, and wanted. But over them all, in Russia and America, is spread the veil of money values giving them all their relative magnitudes in prices. Thus monetary units measure the comparative values of all these real things, price their qualities one against another, and cost all operations, whether for delivery in the present or in the future.

If the authorities in a progressively industrializing society allow these measuring units of all values themselves to alter (by raising the proportion between the supply of money or credit and that of things) the natural variations through time between the values of different things in terms of each other will be altered. New relationships will be set up, not only between the real values of things but between present and future. Wheat normally cheapens through bumper harvests, equipment cheapens through new inventions, expert human skills get dearer because of longer training. But these natural variations between *real* values will be veiled and artificially distorted by an overall variation downwards in the measuring rod, the value of the monetary unit itself. More money will be used for one thing, less for another; *not the same proportion more will be used for each.* Businesses, the State itself, trade unionists, managers, farmers—some of these will get more of the extra money, some less. The total purchasing power of some of them will rise, of others fall. So production of different things will become as distorted as incomes, taxes, pensions, etc., and their real purchasing power.

Finally, distortion will occur between present spending and saving, between consumption and investment, and between lending at moderate rates of fixed interest for medium and long terms and instead not lending at all, or lending at high rates for short periods only, or speculation in increasing numbers of risk-bearing ventures (equities) or commodities, works of art, land, real estate, etc. Consumption and speculation and quick-turnover ventures are thus stimulated by inflation—the more so the more rapid the inflation—at the expense of long-term investment in normal, enduring, productive capital. Inflation thus engenders confusion of all values, hectic velocity of money and dealings and all other

economic activities, and innumerable quick unreliabilities in place of long-term dependabilities.

Steady growth is hampered. The quickest 'turns' on depreciating money are eagerly sought. And everyone soon becomes aware of an undesirable hecticness in the nation's economic life, an unnatural monetary fever. It is too easily and too often mistaken for real and rapid progress in the nation's wellbeing, whereas it is really a hectic boost to present consumption, at the cost of a slower growth in wellbeing than would have been possible on sound money. A lot of purchasing power which would have been saved and invested in durable, productive innovations is dissipated in consumption or in unproductive 'hedges' and hoards.

When this awareness of inflation, of preference for present goods over future goods, becomes general, democratic governments have desperate recourse to State controls and permits over the *real* things, over the normal businesses, jobs, and other economic activities of their citizens. They try to stop the present hectic rush to get rid of depreciating money. They attempt by cooling the thermometer to cure the patient's fever. They attack only the symptoms, not the disease which still proceeds. And so an inflating industrial democracy hampers its own growth, jeopardizes its future, and eventually undemocratizes itself. The inflating democracy inflates democracy away.

Money and the State

The power over, and decisions about, the supply of all kinds of money—cash, notes, bank deposits (bank credit), trade credit, government bills and other short-term IOUs—are in all nations ultimately the responsibility of governments. To allow it to be otherwise would be to go back to the days of private coining, private banknotes, and (of course) very private counterfeiting.

With the vast growth of the modern State's powers over everyone and everything, that State has to raise vast funds to finance both the *current*, day-to-day costs of the State machine and bureaucracy, and the longer-run *capital* projects now undertaken by State authorities, boards and agencies (*e.g.* in Britain, France, Sweden and other 'mixed' economies, the coalmines, railways, gas and electricity services, housing, highways, etc.).

Most of the day-to-day needs of the State are met from taxes. Such current needs include subsidies for State welfare, farmers,

etc, the cost of defence, and the cost of running the National Debt (paying the interest, and repaying the principal when due, of all moneys lent in the past to the Government in exchange for its long-term 'gilt-edged' IOUs or bonds and its short-term IOUs or bills), and the cost of all Government offices, services and staffs at home and abroad. The taxes to defray all these day-to-day State expenses are raised through the yearly Budgets.

If they bring in more than goes out, there is a Budget surplus; if less, there is a Budget deficit. The surplus mops up taxpayers' money and puts it at the State's disposal. If the State then spends it—on anything—out it goes again into circulation to pay firms and people who have worked for the State; and so the surplus disappears. If the States does not spend a Budget surplus, but cancels some of its own paper IOUs with it (reduces the National Debt), the nation's supply of money and credit is cut down. It is deflating to that extent, because the stream of goods and services continues (for at least a time) to flow in the same volume, while the parallel stream of money to be spent on that volume of goods and services dwindles a little. Less money; more goods; prices tend to fall if the deflation goes on. Later on awkward decisions have to be taken by producers of goods and services, as selling prices fall and profits fall with them. Weak producers, producers 'at the margin' who were only just making a profit before, will now make a loss and won't be able to go on doing so for very long. So a series of Budget surpluses which are not spent by the Government is much the same as a credit squeeze in its effects.

But if there is a Budget deficit—*i.e.* if the State spends *more* than it gets in taxes—it must pay its accounts with more money than it is collecting. It therefore borrows from its bankers, who create credit for it, just as a bank manager gives a firm or a private person an overdraft. But there is a great difference between the State's short-term borrowings of bank credit and a company's or an individual's. The State's short-term IOUs handed to its bankers *are* money. They swell the banking system's reserves because they are short-term obligations of the Government and can pass from bank to bank as money. They are reckoned money, because they are reckoned 'as safe as the Bank of England' or as safe as 'gilt-edged'. So when the State finances its own overspending by this means, when it finances a Budget deficit this way, it is inflating the supply of money just as definitely as if it had printed

that amount of new banknotes and pushed them into circulation by paying its due accounts and the wages and salaries of civil servants with them.[1]

There is, however, the second account of the State: not its current day-to-day spending, but its long-term or *capital* account as abovementioned. For that, the State has to raise funds which are going to be locked up for a long time in schools, hospitals, harbours, housing, railways, coalmines, power stations, gas grids, and all the other valuable and durable capital apparatus of the modern State. (Armaments and one or two less important but durable things are by tradition covered in the day-to-day current accounts of the yearly Budget.) These durable assets of the State should yield substantial services to individual and corporate citizens through the years to come. To get the money to make them, the State should borrow at long-term. That is, the State sells its own long-term IOUs, called 'gilt-edged' or Government long-term bonds, to any of its own individual and corporate citizens and foreigners who will buy them at the prices and long-term rates of interest the State must accept.

The State's Tendency to Inflate

There are thus two main accounts which the modern industrial State must watch all the time: the level of its current (day-to-day) account, and the level of its capital (long-term) account. It can raise more taxes than it needs for its *current* account—*i.e.* create a Budget surplus—and then spend exactly that surplus on its *capital* programme. In that case, to cover its whole capital programme, it will not need to offer as many new long-term 'gilt-edged' Government bonds in the capital market. The savings of companies (profits) and of individuals (*e.g.* insurance premiums) flowing into that market for long-term investment will then tend to find fewer outlets. That will tend to lower the long-term rate of interest for borrowing, which in turn will stimulate businesses and other private and public enterprises to borrow and undertake long-term projects to expand productive capital equipment.

But if the State runs a Budget deficit on its current account, or merely balances its current account, yet undertakes on its long-term capital account *more* than it can (or is willing to) finance by selling long-term Government bonds in the market, it will be

[1] See Chapter 5, p. 85.

forced to create credit for itself by the short-term Government IOU method described above. It will then be 'borrowing short' to 'invest long'. It will be overspending *on both accounts added together* at the same time. This wouldn't matter if, to match it exactly, private firms and individuals were willing to save—*i.e.* not to spend so much—and lend to the State at long-term. But they won't be prepared to do this if money is losing its purchasing power already; and certainly not for only moderate rates of fixed interest.

The State will therefore be creating more money than hitherto existed, so that it shall get first cut at the country's existing resources of men, materials and machines. It will be doing this in order to carry out its own spending programmes, before its individual and corporate citizens can buy enough of those same national resources to carry out theirs. The stream of money will immediately swell, but the stream of goods and services—of resources—won't. So bidders will contend with more money for the same volume of resources. The bidder who bids most will get first cut. The State always gets first cut, for it enjoys the prime priority of making new money. And as this inflation of the currency works its way through the country's existing supplies of men's work, of materials and of machine-capacity, the prices of all these resources begin to go up, as the bidders who can afford more outbid those who can't.

The only exception to this way of sparking-off and continuing an inflation is when a nation is in an economic depression or slump, *i.e.* when there are pools of *unemployed* resources—men, materials and machines—lying idly around. Then, the creation of new purchasing power by the State can absorb the unemployed resources, *up to the level of 'full employment' of all resources.* But if the creation of new money continues beyond that level—if the expansion of credit causes a boom, the State's spending and private enterprises' spending now competing for resources which cannot be expanded quickly enough—then nothing can stop the whole price-level moving up and up, as bidders contend with more money for relatively scarcer resources. Orders pile up, delivery dates extend, wage demands soar, profits increase. Full employment rapidly becomes over-full employment.

There are only two possible results to such a boom. First a collapse can occur due to prices soaring beyond some buyers'

reach (generally foreigners' reach, as prices of the country's exports outstrip those quoted by competitors). This brings a sorry relief in the shape of some *unemployed* resources somewhere and a consequent distressing fall in prices, profits and production. Resources are made available again in an unpleasant way. Or, secondly, careful corrective measures by the State will have to be taken to trim State and private spending, so that the flow of money and credit comes once more into balance with the flow of the country's currently available goods and services (resources). No control of prices can resolve this dilemma.

Right Way or Primrose Way?

It is therefore inescapably the duty of the modern industrial State, as it certainly lies solely within its power, to guard against the twin causes of inflation: first, the combined overspending on current and capital accounts by the State, as compared with the funds the State is subtracting (by taxes and borrowing) from its citizens' flow of purchasing power; and secondly, the ordering of its own programmes and those of the nation, through its monetary powers, so that total monetary demands run ahead of the nation's total real resources. If the State does not avoid and avert these two threats to a sound, reliable currency, it will very soon find its own long-term bonds refused in the market. Inflation will be boosting money around faster and faster, as prices rise, and as bidders (the State's boards and agencies included) hurriedly try to get out of depreciating money into the goods and services which are coming forward more slowly than the stream of money. Profits, on paper, rise quickly. 'The velocity of circulation' of money rises. A boom is on. No one will lend at long-term to the State when profits are rising, prices are rising, money is losing its purchasing power, and long-term interest rates over the years do not match the money's loss of its face value.

The standing temptation to States in such inflationary predicaments is to put out still *more* money and credit, to make sure that the State's agencies can buy what they want first. So inflation merrily proceeds. But soon the State and its agencies find they can only 'borrow short', since few lenders will lend their savings at modest rates of fixed interest for years to come. As the State authorities borrow more and more 'short' to finance their over-ambitious 'long' programmes—and, soon, to repay old long-term

bonds falling due—the huge modern National Debts become composed, more and more, first of medium-term and finally of shorter-term Government obligations. National Debts thus tend, in uninterrupted inflations, to become 'monetized': *i.e.* they tend to become composed more and more of short-term Government paper which acts as money; which indeed *is* money within the banking system. And so the inflation feeds its own furnaces, pumping more and more government bills (short-term reserves) into the banks, and enabling them to extend more and more credit (bank money). The result, if inflation is not arrested, is as sure a collapse of the country's currency this way as if the State had simply gone on printing more and more banknotes.[1]

Not the least of inflation's paradoxes is that its inevitable periodic crises compel inflating governments to produce, despite themselves, the very situations from which they hoped to escape by inflating. In such 'crises of confidence' they are compelled, often in abrupt last-minute panic, to raise taxation, clap on controls, and launch 'dear-money' policies which can only suddenly safeguard the currency by making money and credit far more difficult to get, and far dearer if got, than would ever have been necessary if sound money had been maintained all along. Such last-minute, desperate correctives of inflationary crises can only 'correct' by forcing—at long last—some unemployment of men and machines, of labour and capital, upon the society. This is the very situation from which inflation is vulgarly supposed to save a society. No inflation at all is a better recipe for steady growth. It only involves such transitional unemployment of men and machines as is indicated by independent, automatic, neutral indicators, without regular crises and panics.

[1] See Chapter 5, p. 87.