

INFLATION FOLLY

OVER THE last decade the British government has slowly been edging towards an acceptance of the quantity theory of money as the basis for controlling its financial affairs. The former Chancellor Nigel Lawson, even stated on a number of occasions that M0 (which measures notes and coins in circulation) was by far the most reliable indicator of inflation.

As a result, the Treasury has set annual limits to the expansion of the money supply (normally between 1-5%) but it regularly overshoots its target by a considerable margin. Even in the present financial year when a squeeze is supposed to be in operation the average figure shot above 5%, although after last August it was gradually reduced to 3.5%.

As for the broader measure (M4) its average figure for the whole year was 11.1% and its worst 18.2% in January. Even more significant is the fact that, whereas 10 years ago this broad measure was equivalent to about half of gross domestic product, nowadays it amounts to 80%.

This is an unhealthy state of affairs. Even so, the annual influx of extra notes (M0) being

• BRITAIN'S inflation rate reached 9.7% last year, before easing to 9.3% in December - 3% higher than the rates in the USA and Australia, twice the rate in France and three times higher than Germany's rate of consumer price rises.

In his analysis, FRED JONES blames Britain's government, and is puzzled why it was necessary to resort to the printing press to increase the supply of money while paying off the national debt.

printed seems modest enough in itself and according to common sense should not produce more than an equivalent rate of inflation. However, money is not the only means of payment. There is also the system of credit.

Not surprisingly, it is widely believed that money and credit amount to the same thing since they appear to have the same inflationary effects. But this mistaken attitude is largely responsible for much of the present confusion about the true nature of inflation.

In technical terms money is a multilateral contract between the government and the people, and the watering-down of the currency by resort to the printing press has a direct effect on everyone's pocket.

Credit, on the other hand, is a

bilateral contract between a creditor and a debtor, and if a debtor defaults, only the creditor, not the whole population, suffers.

This is because the amount of purchasing power in the system is neither increased nor decreased by credit transactions, it simply changes hands. So it follows that in itself the provision of credit cannot cause inflation.

Instead, what the credit system successfully achieves is to re-channel demand from one potential customer to another, and any reasonably comprehensive retail index must over a period remain unaffected by it.

Yet, whenever the economy goes wrong, the government still tends to use *ad hoc* remedies to reduce what it interprets as "excess credit", whereas it should be looking into the causes that create that excess.

IN THE early industrial era credit was first offered by the goldsmiths and silversmiths who discovered that they could make loans by using the deposits of precious metal in their vaults as a guarantee of their financial soundness.

They also found that they could lend far more than the total amount of these deposits because only about one-eighth of their customers withdrew their valuables at any given moment.

This discovery must have caused the cost of living at the time momentarily to rise until the market adjusted to the extra purchasing power which had been introduced.

But as soon as that once-and-

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will be held in Moscow later this year.

In addition to an international platform of speakers, the conference will feature seminars, workshops, field trips to Soviet developments and an exhibition of designs for new communities, one of which will be for Ararat Garden City.

Christian tradition has often made Armenia the site of the

biblical Garden of Eden. Out of the rubble and devastation of the 1988 earthquake, Armenia could now build for itself a new garden and a new beginning.

By the year 2000, Ararat Garden City could be ready to open its gates onto a new era - as a standard bearer for a nation which, with a history that stretches back towards the beginnings of civilisation, would be ready for a future beyond the 20th century.

for-all blip was absorbed, a flexible credit system proved to be a boon for the expansion of industry.

Moreover, it stimulated expansion without causing any loss of monetary value, because it involved a transfer of, not an extra demand for, goods.

There is therefore nothing wrong in providing credit per se, but only in providing too much of it at any given moment based on a bloated money supply. In fact, an excessive supply of money, especially in the modern world, tends to increase credit and suck in imports from abroad, upsetting the balance of trade.

Since the Second World War this has been a virulent British disease, but the fact that the same thing has not happened in the German economy proves that it is not an act of God.

It follows that the process of ever-expanding credit which successive Chancellors have regarded as an irreparable flaw in our monetary system, and for which the British people as a whole are held to blame, begs an important question: What is the mechanism through which an excess of credit emerges?

It cannot occur, we recall, from within the credit system itself, since for every debtor there is an equal and opposite creditor and their transactions cancel out. So, since credit does not in itself increase demand, the problem must lie elsewhere.

It is, of course, directly, associated with the money supply (M0) which, whenever it is increased, has a knock-on effect on the broader measure (M4) which includes credit.

When governments resort to the printing press to introduce new money, they take real value out but put nothing but worthless paper in. This causes a general rise in prices: all the

other consumers in the market have to bear the cost of the government's inflation of the currency.

At the same time the inflationary process has a dramatic effect on the extension of credit, and proportionally this effect is far more pernicious than the expansion of the currency itself.

The basic rationale behind credit booms is that each extra pound issued by the Bank of England eventually increases commercial bank deposits, and the banks know that once they acquire fresh deposits they can offer extra credit to the public.

Like the goldsmiths and silversmiths of old they operate on the principle that they can safely increase credit by at least eight times their base deposits. However, the crucial issue which we have to examine at this stage is not the activities of individual banks but the effect of an expanding money supply on the banking system as a whole.

SINCE banking is a closed system in which the various major banks settle debts daily with each other, the most important aspect of their interrelationship is to keep in step in their credit operations. Otherwise some banks would fall into long-term debt.

So let us suppose that the government prints and introduces an extra £1,000 into the system. From that point on, whenever a borrower obtains a loan of, say, £1,000 from a bank underpinned by these extra monetary units and buys goods, the seller redeposits the money from the sale in his bank. The second bank's deposits then increase commensurately, and so on.

The argument that the first bank would have to diminish its credit by £1,000 as soon as the

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second bank had acquired its extra credit is not applicable in this closed yet multi-lateral system.

The first bank, following its time-hallowed practice of lending on a multiplier of eight to one, diminishes its credit supply by only £125, not by £1000, after it has paid out the £1000 of the first borrower's loan to the second bank. The latter then similarly lends £1,000 to a second borrower on its new deposit.

Hence the extra credit based on the original increase in the money supply of just £1,000 is only whittled down to nothing after £8,000 of extra credit has been created throughout the banking system and absorbed the extra currency.

The surplus credit remains stubbornly within the system until either the price mechanism raises individual prices sufficiently to adapt the market to the inflationary trend or, alternatively, greater productivity reduces prices to what they were before the extra £1,000 was emitted.

In other words, between the two principal states of equilibrium (that is, the one existing before the increase in the money supply and the other produced after a general price of productivity rise has absorbed it) there is a continuous, if slowly diminishing, offer of extra credit by the banks.

Hence excess of credit is a major vehicle of inflation during this entire period through its disruptive multiplier effect, which seems flatly to contradict our earlier conclusion that the granting of credit does not cause inflation.

It is because of the multiplier effect in credit transactions that the claim has often been made that banks "create" money. Yet what they are actually doing is creating credit.

Although the distinction may

seem trivial at first sight, it is far from trivial when we trace back that extra credit to its source – the expansion of the money supply by the government.

For if the extra £1,000 had not been introduced into the system, the banks would not have obtained their extra deposits and their eightfold expansion of credit could not have taken place.

Surplus credit is consequently caused by expansion of the currency, but once it has been created it proves to be a far more efficient vehicle of inflation than the extra currency itself.

APPEALS to the banks or the public not to make use of it by exercising restraint after the inflationary act has taken place must inevitably fall on deaf ears. Nevertheless the remedy is in the government's hands: it simply has to stop resorting to the printing press.

An apt example in Britain of the process which is triggered by the expansion of the money supply was provided by Nigel Lawson during a television interview with Brian Walden.

Lawson then protested that he had released £4 bn of extra money through tax reductions but that the British purchaser had turned this sum into £40 bn of extra credit. His successor announced in the House that the extra credit amounted not to £40 bn but the £54 bn.

Yet, if the Treasury had held the money supply static when making its tax cuts, little or no inflation would have occurred.

Indeed, Lawson's point that the tax cuts were a mere blip in the system would then have proved correct.

True, there would have been a momentary increase in demand, but when that was satisfied no further credits would appear because there would have been

Ironic risk as Land Acts go

PRESIDENT de Klerk has struck at the heart of South African apartheid with the decision to scrap the Land Acts, which restrict black ownership to 14% of the country's land.

All the other iniquitous laws separating man from man on the basis of colour were meaningless without the forcible deprivation of able-bodied men from land.

For with land, people are independent: and by being able to enjoy competitive living standards, they emerge as the social rivals of any elitist group. That is why the Land Acts, passed in 1913 and 1936, were the lynchpin of apartheid.

The 1936 Act set aside 13.6% of land for black occupation – the area comprising the "independent" and "self-governing" homelands.

- Over 11m blacks live in the homelands, with over 80% earning incomes below the minimum economic level.

- About 60,000 white farmers occupy 70% of the land, and it is this group that has begun to mobilise against the government's actions. The Transvaal Agricultural Union im-

mediately announced a protest campaign by white farmers.

Dismantling the laws does not mean an automatic share-out of the land, for black people do not have the capital to buy out white farmers. The Pretoria government has announced plans to make credit available to blacks, however.

Ironically, the immediate risk is to black-owned land. White speculators could buy land in the homelands. According to Patrick Laurence, writing in the *Johannesburg Star*: "The major beneficiaries on the free sale of land will be the large landholders and giant corporations, accentuating rather than rectifying the maldistribution of land."

Leaders of the non-independent homelands have agreed measures to protect tribal land from being bought by speculators.

- The land question was one of the first causes championed by the African National Congress after its formation in 1912. The ANC regards redistribution as crucial to any negotiated settlement with de Klerk.

no inflationary process to feed them.

Instead, money would simply have been transferred from the government to the tax-payer's pocket with – and this is the important point – no increase in its quantity.

To compound the damage, the ex-Chancellor subsequently allowed nearly £2 bn of extra currency to be printed between January 1988 and August 1989, and even afterwards in 1990 the figure continued to rise.

But to continue the earlier argument, we note that £6 bn of extra liquidity (four of tax reductions and two of extra money) when subjected to a normal eightfold multiplier will quickly produce £48 bn of extra credit. *Little wonder that M4 smartly*

leapt out of control, house prices roared upwards, and inflation doubled.

WE MUST nevertheless stress the distinction between the £4 bn tax-cut in 1989 and the additional billions of freshly minted money.

The tax-cut was not inflationary, though naturally it could for a short space of time suck in extra goods from abroad. This was, however, the result of a short-term adaptation of the market which suddenly found itself having to supply goods for the people instead of goods for the government.

The billions of extra money printed, on the other hand, must raise prices across the board on a permanent basis, or at least

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Property tax slums

MOST of the recent development and buildings downtown and in residential areas of St. Louis have been stimulated by property-tax subsidies that amount to about 16 per cent of the total value of the development.

This subsidy comes from using the Missouri Urban Redevelopment Corp. law, which gives selected sites no increase in property taxes for 10 years and then only 50 percent for 15 more.

That statute also includes power for a development corporation to use eminent domain to acquire property in a legally blighted area. Applied in a spotty and discriminatory manner, this tool of tax abatement has spurred development, but at what price?

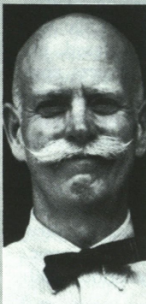
This development process in St. Louis tends to be discriminatory and arbitrary for many residents and businesses. Eminent domain has been used as a legal lead pipe to club property owners into submission and into selling property against their will. Such abuses undermine confidence in our legal system.

Most of those who complain about the current system focus on more government subsidies instead. But no programme to stimulate production of housing will succeed so long as the property taxing system is backward.

Why shouldn't every property owner get the benefits of tax incentives for improvements instead of the favored few? The current system is at the expense of the great majority.

The present property tax system in St. Louis, and most of the country, is inherently counterproductive to a well-developed, well-maintained city with reasonably priced housing. In the long term, government subsidy programs compound the problem by addressing symptoms only. They tend to raise the cost of land to the detriment of development. People who

• *Architect W. Philip Cotton Jr. (right) reports from ST. LOUIS on the fiscal impact on the urban environment*



improve their property, rebuild the porch or add a room probably will be punished with a higher assessment and higher taxes. Thus is maintenance and improvement of property discouraged and even penalised, while dilapidated buildings are rewarded with lower assessments and lower taxes.

Taxes should be removed from buildings and improvements. Public revenue should come from the "location value" of sites. A switch to this basic principle would reward conservation and improvement of buildings and penalise those who hold valuable locations out of use, inaccessible to those who need them most urgently for houses and businesses.

Pittsburgh is one of 12 U.S. cities that uses this method of getting public revenue. Since 1979, Pittsburgh has taxed locations at six times the rate of buildings and enjoys great benefits including:

- (1) The least expensive housing of any major U.S. city, because the site value charge helps lower the price of land and encourages construction.
- (2) Very little vacant land in the central business district (unlike St. Louis).
- (3) Ranked most livable larger U.S. city by a recent Rand-McNally study.

(4) Ranked first by a large margin as the city with the lowest crime rate, in all categories, among 435 cities.

Most arguments against site-value taxation are smokescreens. One is that it is more complicated to administer. The opposite is true. Assessing only the location tends to be more accurate, fair and easy to check. Not having to assess buildings and improvements reduces the time and judgments required.

One large Australian city, Sydney, derives all real property revenue from charges on location values only and levies no taxes on buildings or improvements. It has few if any slums!

Melbourne, which taxes improvements and buildings heavily, has the usual slums, the result of penalising owners for improving their property.

Many studies in cities where it is used show clearly that a switch to site-value taxation results in lower taxes for 75 to 85 percent of homeowners and the vast majority of businesses.

This assumes collecting the same revenue. A 1983 study of 1,000 parcels in St. Louis by the Public Revenue Education Council found that 85 percent of homeowners would enjoy lower taxes under such a shift.

Our Missouri constitution mandates taxing buildings and the site at the same rate whereas the Pennsylvania constitution permits larger cities to shift taxes from buildings to locations.

We must persuade Missouri legislators to allow a vote to change our constitution to give local communities the option to make such a shift if they so decide.

As long as our property-tax system is fundamentally geared to encourage the spread of slums and penalises improvements, no government subsidies and laws to the contrary will stem the tide.

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until rising prices have worked through the system to counteract the inflationary effect.

Across-the-board price rises are thus the only valid benchmark for measuring inflation. The occasional blips caused by special circumstances such as

temporary shortages, natural disasters, threats of war, etc. can be completely disregarded.

The conclusion must be, therefore, that the one sure way to call a halt to every-expanding credit facilities is to control the money supply, but even now Britain is still awash with extra currency because of the finan-

cial slackness implicit in the 1-5% annual increase permitted by the Treasury.

Indeed, why the government, which is certainly not short of funds, should even want to inflate the currency while simultaneously paying off the national debt remains an unfathomable mystery.