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Development and a 3% Base Deposit Rate

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1. Introduction

The paramount justification for government intervention in economic activity is raising the potential standard of living for the poorer eighty percent of the population. Yet governments can no longer develop their monetary and fiscal policies in isolation, however much they may wish to do so. Economic dynamics are too closely intertwined with international trade, credit and development. Moves to tax a developed economy, either fiscally or monetarily, have knock on effects on the rates of growth of trading partners as well as on those of the less developed and/or deeply indebted nations.

Perhaps this implies that in the future, before fiscal and monetary policies for a country may be determined, it will be more and more essential for governments to consider how their strategies will affect the international context of development; not so much for altruistic reasons but rather out of enlightened self-interest. The costs of ignoring the interests of their neighbours could otherwise prove too high over all but the short, politically expedient, term. Accepting this to be the case, we have to review the main problem affecting world development: how to furnish the international liquidity and credit which is genuinely needed without simultaneously creating international inflation.

Looming large over this problem have been the International Monetary Fund (I.M.F.), the International Bank for Reconstruction and Development (World Bank) and its affiliate institutions, the International Development Association (I.D.A.) and the International Finance Corporation (I.F.C.). Whilst the I.M.F. was originally set up to run an international monetary system for countries with fixed exchange rates, the others were founded to perform tasks for which they were never given adequate resources. Nonetheless, the I.F.C., founded in 1956, has managed to play its part in promoting investment in private industrial and mining enterprises, mostly in the

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developing countries, and the I.D.A., founded in 1960, has furnished a considerable amount of direct support to agriculture.

In the meantime, the I.M.F. became the organiser of rescue packages for countries in trouble, has received most of the publicity, much of it unfavourable, and thanks, if any, have been begrudging. The reasons for this are easily recognised. Few patients enjoy strong medicine, especially when accompanied by a rigid diet. If the cure works quickly there may be appreciation for the prescription, but, if there is a noticeable lag before results are felt, there can be considerable resentment about the length and the cost of the treatment. Trouble really arises when the treatment is overdone and the side effects are worse than the original ailment. The doctor is blamed.

Underlying the criticism of the I.M.F. lies the woe that betides the ordinary people of the countries which have to agree to the proposed remedies. In the event, it is always the poorer people, those who are unable to make ends meet, who again have to defer their fragile hopes of living free of indignities.

Supporting the I.M.F.'s approaches, the financial establishments of the wealthier nations have stuck to their shibboleths. Restrain the levels of wages, say their pundits. Earning enough to have a dignified standard of living is inflationary. It puts too much demand into the economy. Restrain those investments which will increase overall production and reduce unemployment at anything more than a crawling rate. They create overheating. Restrain the rate of growth and the enthusiasm for self-development. They create pressures for a quality of life which our system cannot accommodate. The population will have to live with less improvement in their standard of living or development will have to be curtailed, using the seldom recognised form of taxation imposed by high interest rates.

Assuredly, there is a better way of dealing with demand problems. It involves putting the engine at the front of the train, creating tax incentives for production and directing credit away from consumption to favour investment in expansion and new enterprises. This kind of investment creates production and strengthens levels of employment. The resulting earnings increase the absorption of production throughout the economy. If these earnings have been linked to productivity, costs are held in line and exports become more

competitive. These are the achievements which maintain a healthy exchange rate and, consequently, a positive international credit rating while the country achieves further growth.

The I.M.F., however, has come up with no such formula, in spite of the somewhat lonely efforts of its managing director since 1987, M. Michel Camdessus, who appears to lean in the direction of giving the organisation more of a long-term development agency role. Constrained by its main remit to furnish short-term finance for nations with balance of payments problems, it has simply cobbled fresh heels while, from time to time, the G7 central bankers stitched new soles onto the system's worn out shoes, each 1% rise in lenders' interest rates adding roughly U.S.$4 billion to indebted nations' annual servicing costs. Ever eschewing ideas of taking new approaches, their main concern has appeared to be to preserve the tenuous stability of banks who made unwise sovereign loans, funded too much real estate development or backed too many leveraged buyout situations. Creating conditions for growth within the LDCs has been distinctly a second priority.

This is the point. The system's existing approaches cater mainly for half a job – the negative, restrictive, side of the equation. They fail to allow for maintaining countries' abilities to foster employment, unless their economies are already taken to be basically sound. Normally, the measures demanded make for serious set-backs in living standards, as witnessed by the increase of misery abounding in even recovering debtor nations.

The political, social and economic returns to be obtained by modifying the present system are recognised but, as was pointed out by Denis Healey, trying to achieve practical changes is like rowing through treacle. Every government knows how much better off all would be if each gave a little here and there, but too many of them maintain an obstinate resistance to modifying their own stance. Competing home priorities make them defend their corner and give no ground, whether mutual dependence is obtrusively a fact of global life or not. One wonders when, if ever, they will recognise the principle that open economies have to be developed along parallel paths?

The needs of the countries of Eastern Europe and the republics of the erstwhile Soviet Union make the requirements for radical

change all the more essential. The economic rescue mission has the hallmarks of a prime emergency. Even if basic humanity didn't demand truly rapid responses, it surely has to be clear that the future prosperity of the developed world may well depend on its ability to integrate these countries within its pattern of progress.

Modernising the system may not be so awesome a task as has often been suggested. But, before it can be contemplated seriously, one basic cornerstone has to be laid: the co-ordinated containment of real interest rates, at least between the major trading nations or blocs.

2. Assessing the cost of high interest rates in the context of economic development, we can well bear in mind Schumpeter's important distinction between capital and entrepreneurial credit. The existing stock of capital is already employed within the circular flow. Credit, therefore, has to be created to fund the new, innovating, enterprises[1]. The debt money produced will constitute new money, in clear addition to the established amount of legal tender, and the amount of credit which is issued will depend on the backing generated by the multiple deposits within the banking system.

Recognising this, we can reaffirm the axiom that "trading in credit for the purpose of financing development is the principal function of the capital market"[2]. We note that for economic development to take place it has to be both growth-inducing and growth-sustaining, so that changes in the industrial structure will yield higher productivity and higher real average income per working person[3]. But, for this to be achieved on a steady basis, monetary policies have to be geared to enable the provision of credit at interest rates which will vary only within narrow limits.

The concept holds equally well for the more mature as for the developing economies. In all of them, credit needs to be furnished in such ways that the servicing of loans will not constitute unexpected brakes on planned progress. Consequently, if plans are to be made for

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1 SCHUMPETER, J.A., *The Theory of Economic Development* Oxford University Press, New York, 1961.

2 SCHUMPETER, J.A., *The Theory of Economic Development* Oxford University Press, New York, 1961.

3 FIRESTONE, O.J., *Industry & Education*, University of Ottawa Press, 1969, Cap. 10.

development along parallel paths, and they have to be in order for there to be any lasting international stability, a co-ordination of low interest rates★ will need to become a cornerstone of international monetary strategy.

Any proposal that interest rate levels be held down as a matter of principle touches tender spots in political nerve systems. The manipulation of these levels has been a prime tool of national monetary policies. Ostensibly, decisions to raise interest rates are taken in order to combat what the establishment contends are existing or incipient inflationary pressures. This is what generates many of the subsequent complications, because the accepted wisdom that higher interest rates damp down inflation is demonstrably erroneous.

Raising interest rates may cut into demand, eventually, but always via the reduction of industrial activity and employment. It is the drop in employment levels and the consequent losses of income which cut the purchasing power of the population. It depends on the rigor of the measures which were taken whether the economy will merely go into recession or into a fully fledged depression.

Raising interest in artificial ways is about as useful to the body economic as was leeching to the body physic. While the tactic may alleviate some pressures temporarily, it invariably leaves the patient weakened. It is a high priced cure for demand-pull inflation and simultaneously constitutes one of the most virulent factors underlying the cost-push variety. Each interest rate rise jacks up cost calculations at once. These feed straight through into pricing. Very soon there are demands for wage increases to offset the higher costs of commitments to mortgages, bank loans, car payments and the like. The lag is all too short before the purportedly approaching inflation is in fact provoked by the supposed counter weapon. The confused authorities profess surprise at the symptoms and disappointment that their medicine isn't having the desired effect. They double the dose.

Yet the increased cost of credit does little or nothing to deter weak borrowers, as is so often one of the contended objectives. The average consumer looks at the size of the monthly payments, not at the cost of the loan. The area where the tactic bites hard is in that of

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★ Please note the evidence of present disparities shown in Appendices B & C.)

house mortgages. Yet there are better ways to restrain soaring house prices than penalising everyone who is trying to pay for a home.

Businesses which are in danger will pay almost any price to ward off disaster. It is the strong companies which are deterred from borrowing, the very ones whose continuing investment outlays keep an economy healthy. Assuredly, these companies are not going to gear their available investment capital with expensive debt, when they can see the risk-free alternative of placing their money in high yielding government paper. Instead, as the price of their products begins to become uncompetitive, they are obliged to cut back on production, laying off their workers and starting the roll of a new stagflation snowball.

On the international scene the carnage can be even worse. Each time that central bankers decide to defend exchange levels for first one of the major countries, then another, then the next, not only does international trade go into recession but the upward spiral of loan costs twists viciously through the debtor countries. Once again, recovering economies are lifted off their feet, the effects of accepted disciplines are destroyed, and the alleviation of social degradations recedes still further into the future. There has to be a better strategy and a combined political will for it to be used.

It may be interesting to digress at this juncture, in order to note some of the main points of the macroeconomic debate which has been pursued since Keynes produced his General Theory of Employment, Interest and Money. Especially because, although Keynes may well have been concerned regarding the difficulties of obtaining the information required by the market economy, if it is to function efficiently, and particularly with respect to the communication of this information, it may be fair to say that this was not his primary aim.

What Keynes was seeking to do was to lay the groundwork for intervention by governments to manage demand, chiefly by fiscal means. Thus, he maintained, expenditures within the economy could be influenced sufficiently to maintain high levels of output and, therefore, employment. At the same time, he had to make the proposals acceptable enough to the classicists for them to concede the possible validity of his doctrine, even though he hadn't fully expounded its theoretical basis.

The essential belief, which he managed to have at least partially accepted, was that the macroeconomic characteristics of the economy are determined principally by demand. He died in 1946 without

having elucidated his own later thinking, mainly because he had been occupied as the leading economic advisor to the British Government throughout World War II. He had suffered a heart attack back in 1937 and there was only so much of a load that he felt able to carry.

His post-war disciples, however, were able to point in vindication of his doctrine to Britain's experience during the war. The ability of the government to exact heavy taxation and impose controls had enabled the successful prosecution of the war. The same, they contended, should enable post-war reconstruction and the foundation of the welfare state. Demand management and comprehensive socialisation of investment were deemed appropriate and would maintain conditions of full employment, as the country swung from large armed forces and the production of huge quantities of weaponry.

Nobody appeared to realise the importance of the part played by the low cost of the abundant liquidity available. Funding was possible because expectations from 'gilts' were still modest. But there was trouble storing up for the years ahead, as the costs of the nationalisation of industry rose higher and higher. Deficits were to grow, both internally and in external trade. The government would be forced to pay more and more for its borrowing, fuelling inflation as though it were stoking a furnace.

Meanwhile, Keynesian doctrine was growing and in the ascendant. Hicks and Hansen blended it with classical theory while, in general, argument continued mainly about specific aspects. The 1959 Radcliffe Report gave it victory in British banking and financial circles, where even the Treasury was dispensing with monetary considerations as it built its models[4]. U.S. official circles also became convinced of the viability of the theories. The 1960 Economic Report to the President (Kennedy) made the case for them as forcefully as possible. It led to the 1962 twelve billion dollar tax cut, a fiscal measure with which even opponents of Keynesian economics had to agree, since it also lay at the heart of supply side strategy. Keynesian influence was at its zenit[5].

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4 SHAW, G.K., *Keynesian Economics,* The Permanent Revolution Edward Elgar, 1985, pp 29 & 30.

5 SHAW, G.K., *Keynesian Economics,* The Permanent Revolution Edward Elgar, 1985, pp 29 & 30.

The Keynesian Theory of Money had postulated that the general price level depends on two things: wage rates and the scale of output. To wage rates had to be added the rates of remuneration of other factors which enter marginal costings. But the dogma which he maintained, as to wage rates being by far the most important factor of total factor costs, has set up the stumbling block over which many situation analysts continue to fall unheeding. Because of it, the belief has been inculcated that inflation can be contained by policies which keep down rises in money wage rates. Yet these policies have never been shown to succeed. It is another factor, the going rate for the alternative use of money, which has greater effects upon costs, with considerably less lag. Ignoring this, policy makers have tried to manage demand at exactly the junctures when they should have been aiming to increase output by stimulating investment and G.N.P.

What counts is not the level of wages relative to prices. It is the level of wages relative to total output which will determine stresses within the economy. Also, since from a social stand-point money wage cuts in real terms are retrograde measures, and since the same effects are achieved more rapidly and acceptably through increases in the money supply, the clear course of action has to be one of increasing output to satisfy demand, leaving the increased G.N.P. to balance off against the increased supply of money. Besides, natural aspirations make it virtually impossible to restrain demand, unless the economy is first thrown into reverse by heisting interest rate levels in so draconian a manner as to undermine large segments of industry.

The traditional quantity theory of money purported to show that an increase of the stock of money would be translated into price changes in a fairly predictable way. But in 'Studies in the Quantity Theory of Money' (1956), edited by Milton Friedman, the theory was revised to mean that the change would be in the value of money income, the change being reflected either in output and/or price. According to Friedman, the real demand for money is determined mainly by the level of permanent income and the rates of return on real financial assets, by comparison with the rate of return for holding money. His conclusion (1968) was that "substantial changes in prices or nominal income were almost invariably the result of changes in the nominal supply of money."

Friedman thus acknowledged Keynes' point that the demand for money is a function of the rate of interest. Where he differed was in the degree of responsiveness. The revised quantity theory postulated that substantial falls in interest rates could be expected to produce significant effects on both investment and consumption outlays. This implied that changes in the money stock were the primary cause of change in nominal income. Keynesians remain firmly convinced that fiscal policy changes are the more effective. They deny that the demand for money functions in a stable way, and maintain that the velocity of circulation of money is highly variable. The polemic could go on for a long time, both sides clinging to the idea that inflation can be controlled by constricting the availability of cash. This may have held in the first half of this century. It is not valid in cheque money economies.

The rate of interest, Keynes wrote in an article for the Quarterly Journal of Economics in 1937, is the "premium which has to be offered to induce people to hold their wealth in some form other than hoarded money". In those days it was still possible to say that people might desire to hold money in the form of inactive balances, or 'hoards', in order to protect themselves from future risks or uncertainties. Nowadays, since they can easily obtain modest rates of interest for bank deposits over periods as short as seven days, except where the amounts may be regarded as minimal, and since many banks also offer daily interest on chequing account balances, cash will readily be held within the banking system rather than 'under the mattress'.

A link between the level of savings and investment is tenuous nowadays, to say the least. Monetary policy may change expectations with respect to the investment outlook. Nevertheless, fluctuations in Effective Demand cannot be accounted for simply by relating realised income to money supply. Effective Demand corresponds rather to the income for the entrepreneurs the expectation of which has set production movin[6]. Consequently, it is production which stimulates demand, not the level of national income. Increases in income create savings eventually, but only after wider demand is satisfied. The

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6 KEYNES, J.M., *The General Theory.....* MacMillan, 1967, p. 55

wider demand engenders innovative enterprise, new jobs and further production of goods and services from new companies, whose finance is furnished through cheque money (credit). Thus, it is credit which is the main source of investment, whilst the price of money governs where existing capital will be applied.

3. The Price of Money.

All economic activity has to revolve around the value attributed to money. In the past, theorists believed the determinant to be the value attached to labour. Socialism wished to extend this to the total worth of the members of a collective whole. This was wishful thinking. No enterprise is set afoot without money. A project is funded either by capital or by credit or by a combination of the two. Its viability is determined by the cost of the funding. The cost of the labour involved is secondary. It could prohibit the progress of an enterprise but it cannot set one in motion. Money alone primes the pumps.

Whether it may be regrettable that so much turns upon the value of capital is immaterial. It is a point for moralists. Nor is it relevant that the intrinsic worth of a person's efforts counts for little in the general scheme of economic life. Several generations might have to pass before the situation may be different. In the meantime, the rules are:

a) The viability of an enterprise depends primarily upon the ability to manage its cash flow in such a way that there is enough money available to meet current commitments. The operation may be highly profitable, technically, but, if the cash flow doesn't cover the gaps between expenditure and income, there will be a hiatus which can lead either to a damaging slow-down or a costly suspension of activities.

b) The cash flow has to be secured by the managers through adequate arrangements for the provision of both capital and any necessary credit to cover anticipated as well as emergency shortfalls of trading income.

c) The cost of rewarding those who furnish capital and credit determines whether the enterprise may go forward. If the cost is

prohibitive, in the sense that it will take too high a proportion of the potential added value that can be earned by the project, then all else is irrelevant. However much labour costs can be squeezed, or other costs minimised and controlled, makes no significant difference. If the money cannot be hired within a set proportion of projected total sales values, the operation will not be worth the candle. At some point in the near future, there won't be enough money to pay other creditors. Shortly after that, there won't be sufficient even to pay wages and salaries. All other costs can be offset by careful controls and planned pricing, a high cost for money cannot. It looms too large in the equations which have to be worked out.

(See also the argument included in Appendix D.)

d) The amount of development activity within a country varies inversely with the prevalent levels of the key interest rates. Included in these key rates are those being offered by government treasury issues, since the fact that their returns are guaranteed directly affects considerations of the alternative merits of investing capital into industry with all the concomitant risks. When we recognise this and recollect that development is the essential ingredient in any viable mixture of measures aimed at alleviating poverty, hunger, ignorance and disease (P.H.I.D.), we are drawn to realise that the containment of interest rates on a world-wide basis is a matter for statesmanship and of a paramount priority. Implicitly, since no one or two countries could pursue this policy in isolation, the containment would have to be concerted under the terms of an agreement that would bind at least the twelve major trading nations.

e) Underlying such an agreement would have to be the knowledge that it will stick, by virtue of the people most involved, the world's bankers, subscribing to the decisions, not simply as things with which they can live but particularly as measures which will underlie the functions of a more efficient system. This will be possible only if they believe that they will still be able to obtain fair rates of return for the risks that they have to run as they fulfil their various roles. Moreover, since banking and investment institutions underpin all modern economic relationships, it will be essential that a fair rate of return is indeed determined and agreed.

4. How much is it reasonable to charge for the use of money, either as a depositor or as a lender.★

Should money be entitled to any rent at all, if the resources of the earth belong to all of mankind and individuals are merely stewards of varying amounts? Is usury, for example, acceptable up to a certain level and how should usury be defined? These philosophical questions are among the most perplexing and vexing that are ever posed to financial people of goodwill. Attitudes toward the questions vary with the egocentricity of the individual involved.

Investment and banking circles require very many egocentrics within them to produce the ingredients which make for financial successes. Yet the people involved are no more greedy or venal, as a class, than accountants, businessmen, doctors, engineers, lawyers or politicians. They simply prosecute their goals and defend their trade's interests in the best way they can.

At the same time, even though higher risks may arise, opportunities for financial entrepreneurs can be considerably greater than those for industrialists. It seems strange, therefore, that they should so often espouse policies that are likely to lead to recessions and, because of these, to great difficulties for their own businesses. Why, for instance, do they so often encourage, press for or simply defend high interest rates? The rationale seems to be as simple as it is hidden when not being sought out. If, by dint of skill and hard work, investment managers can improve the performance of their portfolios by only small margins of, say, a half of or even a full percentage point, they will assuredly embrace ways to gain more and at the same time reduce risk. Since these ways are available to them every time a government pays higher rates for its borrowings, trends in this direction are, quite naturally, likely to be abetted.

It is this tendency to seek higher yields from government treasury issues which militates against the lower rates of interest that would be more beneficial to the economy as a whole. Governments, of every persuasion, discover that treasury officials, central bankers and other personalities within the financial establishment bear down on the options. The 'economic facts of life' are paraded and political will is frustrated. Ministers protest occasionally, sometimes loudly

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★ The former being an amateur and the latter a professional.

enough to catch attention through the media, but a jetstream of propaganda swiftly carries these protests away. Of course, profligate governments, when they see large borrowing requirements ahead, may well connive at the so-called financial establishment pressures, especially if they foresee an inability to persuade national institutions and foreign investors to take up their bond issues without increasing their nominal yields. In the U.S.A. the players may be lined up in different ways but the effects are similar. Fiscal changes may be legislated for but no-one manages to challenge the monetary system for very long, even if, from time to time, the administration contrives to persuade the Federal Reserve against its instincts.

The strangest thing in this tug-of-war is that banking and investment institutions appear to be acting against their own best advantage, because they always enjoy greater benefits when money rates are relatively low. Since this means that there is no inherent contradiction which would make them unable to profit in an environment where interest rates were restricted to low levels, there can be precious little reason for them to favour the higher rates. There are so many ways to make parallel profits. Many banks already use two or three and the spread of one stop financial centres will make the process even easier. If, therefore, the money markets were permitted to function free of artificial manipulation by central bankers, there would be no serious obstacle in the way of keeping interest rates within basically small margins. The stop, go, stop effects of monetary policies on economic development would be eliminated. P.H.I.D. could be tackled on a continuous basis and any excessive demand contained by selective taxation.

The necessary condition for making this possible would be an elaboration, fully acceptable to all the parties involved, of a range of interest rates which will afford institutions the yields required for their basic lending businesses to be and remain viable. The successful functioning of banking and investment communities is quintessential to modern society. They are pivotal to each and every economy other than the most primitive. At the same time, the very wide powers conferred upon them are sure to devolve on them certain obligations. These don't go so far as to require them to develop systems that will afford the greatest benefits to the societies in which they operate, but they do have to co-operate broadly with the authorities in the

prosecution of economic policy. Clearly, if the goalposts are going to be moved they will wish to negotiate that equitable range of interest rates which will accommodate new strategies as well as international co-ordination.

5. **In determining what should be an equitable rate,** three specific axioms should be borne in mind:

a) Assuming that there is no artificial manipulation of a central rate by authorities, the price which has to be paid for deposits is the key cost underlying calculations of the price to be charged for credit (cheque money).
b) The price which will be sought for deposits is directly relative to whatever returns are available from alternative placements and/or investments and their comparative safety.
c) The viability of a credit granting operation depends upon the returns to the lending institution being real.
It stands to reason that depositors also require a real rate of return.

Many seekers of safety may be unsophisticated about their money a how it might be better placed. But the larger depositors, those who are more attractive to bankers, do expect to receive a reasonable income. They want a steady amount of purchasing power credited to their accounts on a regular basis.

It may be fair to generalise that such depositors have been satisfied by an average *real* rate of return of 3% p.a. The statistics available are set up on such variable bases that they will provide no more than approximate evidence. It could take a month of Sundays, certainly far longer than is appropriate to the purpose of the present discussion, to tie down a precise figure. May it suffice to say that the satisfactory rate appears to vary between 2.5% and 3.5%, the higher figure pertaining when expectations of inflation are more prevalent. If we then take the average of 3% as a basis cost for lending institutions, we can project from it to arrive at a recommended range within which to constrict interest rates for loans.

The next step is perhaps the easiest: adding in a cost for administration. Again in general, the average costs of loan administration for an efficient institution may be taken as varying between 1% and

1.5% p.a. Putting it at the higher amount for the sake of safety, we can add this to the basic cost for deposits and bring total costs so far to 4.5% p.a.

The difficult step is the final one, since it is unlikely that there would ever be a lasting agreement as to how much profit is sufficient. Circumstances vary so greatly with each undertaking. Instead, we have to put forward a hypothesis, using an *arbitrary* figure, and then defend it as one with which everybody involved could work.

Given proper motivation, it is possible that the *arbitrary* figure of between 1% and 2% for profit might be deemed to be potentially acceptable. The confessed reason for picking these particular numbers is that they furnish us with totals within a highly desirable price range for credit: from 5.5% for low risk loans to 6.5% for those where the projects inherently have to involve more risks. The range is desirable, because it is the one where what we may call 'best balance' is struck between the advantages for the economy as a whole and those for the institutions which provide the money to its industry.

The motivation is there, even though at first sight it may not be as satisfying as some would seek. The closer look shows that both sides benefit the most when lending rates are within this 5.5% to 6.5% range. Industry sees its borrowing costs nicely within the acceptable proportion of overall costings for projects to be and remain viable. The banking and investment people build better value portfolios and balance sheets. And, because credit is being provided without its costs putting strains on fledgling companies and inhibiting established corporations from investing in growth and expansion, the economy is healthier.

There is another excellent reason for keeping lending rates within the 5.5% to 6.5% range.★ The real return from government bonds is higher at times when the absence of monetary intervention by the authorities leaves the market to find its own level. Although it might seem that real yields could improve after central rates have been jacked up, bond markets know better. Bond values will have been discounted in recognition of a likely rise in the rates and they will be discounted further after the event, in an instinctive recognition

★ Please also see Appendix A.

of the fact that the manoeuvre will generate inflation, and that this will become evident after as little as two months. Then, when the subsequent increases in interest rates peter out and the bond markets have reached a nadir, real yields will be at their lowest.

For example, in the U.K., after the spate of increases to defend the exchange rate of Sterling during 1988 and 1989, the long gilt yield at the beginning of August 1989 was down to just over 9%, whilst the inflation rate was 8.3%, giving a real rate of return of a mere 0.7%. Compare this with the time of low interest rates in 1984 and 1985, when the real return was around 4%. Subsequently, as monetary screws were tightened around the world, with but a brief pause after the central bankers had taken the process too far and triggered the 1987 crash in markets, real yields declined almost everywhere, the decline being particularly sharp in the first half of 1989. Two exceptions stood out: Germany and Japan, whose central bankers deftly resisted pressures from the American and European establishments and refused to do more than respond to their internal market forces.

6. Conclusion.

Looked at within the overall scenario that has been described, the foundation stone for an indicated range of interest rates for bank loans is what could be named the '3% Base Deposit Rate' (3% B.D.R.). It should be understood to imply both a real rate of return of 3% for the depositor and a lending rate, calculated from this base, which in turn generates a real rate of return for the lender. *It would be surprising if the debate were not hot and strong as to how wide the range for the lending rates should be.* Nevertheless, it may be crucial to fix the B.D.R. itself at 3%. From it can stem a new financial system, the logic of which would not only provide cement for a proposed broad agreement, but also enable the agreement to hold and serve the next generation or two.

Appendix A

Sight of the particular significance of this reason should not be lost. It refutes the *viability* of the principal aim of investment professionals when they urge higher interest rates. Their objective, of course, is to obtain better yields for their portfolios through higher coupon issues from the treasury. But if these yields are going to be eaten into by cost-push inflation and, as a result, be lower in real terms, the exercise will be self-defeating. Granted, when the interest rates drop back down again, there could be a capital gain to be realised, but since this only partly compensates for the otherwise low real returns, the game is fruitless.

An interesting confirmation of this may be obtained by making a review of past recommendations emanating from British unit trust and investment fund managers as equity markets lost their lustre. Urging people who required high income to invest in 'gills' portfolios yielding double digit figures, the implication was that there could be capital gains to be had in due course, in addition to the income along the way. Yet the record almost invariably shows that the experience of such investors has been disappointing. The capital values of their units declined each time that the bond markets weakened. When they strengthened again, the recovery in capital values seldom left them much higher than at the outset, and this was frequently after one or two years had passed. By then, however, the income yield of the portfolio was somewhat lower than had been available initially. It thus transpired that the hoped for high yield was only available at the expense of the original capital sum, the income therefrom and the purchasing power of both.

Appendix B.

WIDE DISPARITIES BETWEEN INTEREST RATES

Source: October/November, 1994 Money and Capital Markets bulletin prepared by the Bayerische Landesbank Department of Economic Research.

Real Interest Rates in the principal international investment currencies range from 4.5% to 8.9%. Investments in Canadian Dollars offer the highest return in real terms, as measured by the yield on ten-year government bonds less the latest available inflation rate, while D-mark bonds yield the lowest return on this measure. With a yield of more than 9 % and a year-on-year inflation rate of 0.2% in September, the real interest rate in Canada is currently no less than 8.9%. Denmark, with a real interest rate of 6.8% comes second, followed by

France (6.4%) and Spain (6.3%). Italy and the U.K. follow with 5.9%, Switzerland and Japan with 5.5%, Portugal with 5%, and the United States and Germany bring up the rear with real interest rates of 4.8% and 4.5% respectively. The real interest rate in all countries is above the multi-year average, which in the case of Germany is slightly below 3%. An interesting feature is that countries such as France, Spain and Italy, whose currencies – contrary to what many had expected – are keeping stable against the D-mark, have high real interest rates. By contrast, in Japan and the United States real interest rates are much lower.

Appendix C

In July 1995, The Bayerische Landesbank's Department of Economic Research bulletin noted that the average yield on (German) public bonds and inflation were in step for several years, having reached their highs and lows at roughly the same time since the mid-1970s. The average bond yield and inflation had both peaked in 1974, 1981 and 1990/91. An average yield of 10.6% and 8.9% in those years compared with an inflation rate of 6.9%, 6.3% and 3.6% respectively. By contrast, in 1978 and 1987 both the average bond yield and inflation hit a low. Inflation dropped to 2% in 1978 and even turned negative (-0.2%) in 1987. In 1994/95, however, the average bond yield and inflation became desynchronised. While it had taken the past two price and rate cycles more than seven years (from 1971 to 1978) and six years (from 1987 to 1993) respectively, to move from low to low, the current cycle was then (mid-1995) only in its second year. With an average bond yield of just over 6.5% and an inflation rate of less than 2.5%, investors were in a position to reap similarly high real returns in 1995 as they did in 1994.

The interesting thing to note is that these high real returns were due mainly to the Bundesbank's stubborn refusal to bring down interest rates at sufficiently early junctures. With the consequent repercussions on the German economy, causing economic slowdown, increasing lack of competitiveness in world markets, the resultant restructuring of industry and significant rises in levels of unemployment. All of which could have been largely avoided if interest rate levels had been brought down so as to keep them in line with the previously long standing average real interest rate of 3%.

Appendix D

Amendola and Gaffard in their paper, 'Intertemporal complementarity and money in an economy out of equilibrium.', J. Evol Econ (1992) 2: 141, start their subsection, 'Money endogeneity and the specific role of banks', by

stating: "The model and the simulations, highlight the intertemporal complementarity between financial and productive assets for the viability of the process of change. The flow of additional liquidity – also by affecting the intensity of the innovation process and hence learning both in production and consumption – appears as an essential element in determining the actual time profiles of proceeds and expenditure on the consistency of which the viability of the process of change ultimately depends[7]. However, it is worth stressing again, in this context money matters as a quantity (the amount of financial resources available) not as a price: the interest rate has no relevant role to play in it[8].

I argue that *with their last sentence* they miss the point, in spite of the fact that the previous section of their paper had been devoted to 'Exploring the sequence for viability'. Because it is the amount of financial resources that are available *on a viable basis* which is of importance. Therefore the interest rate is indeed relevant, because what makes the availability of resources viable is the cost of the money involved. If it is too expensive the project will not be embarked upon. Moreover, although Hicks
might have been strictly correct in saying that "it would *rarely* be advantageous to stop it in the middle, however high the rate of interest.", he has overlooked the fact that a consideration of this sort frequently brings a business to disaster. Whereas the mark of a good entrepreneur is shown by how fast he puts and end to a project when costs start telling him it is wrong.

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[7] Schumpeter (1934 had already stressed the importance of credit (creation of liquidity) in making it possible to *shift resources* from current to innovative productive activity. We go further. In the model proposed additional liquidity is essential for making a process of *creation of resources* viable, which it does by helping to take care of the most important problem to be faced in this process: that is, that inputs come before output in an essential way.

[8] Hints of this can be found in the last Hicks: "A project cannot be started in the middle: and it would rarely be advantageous to stop it in the middle, however high the rate of interest" (1989, p.119)

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