

John Mills

WHY THE WEST IS FAILING

Failed Economics and
the Rise of the East



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John Mills

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What Has Gone Wrong?

For decades, the West – broadly defined as North America, Western Europe and, more recently, Japan – has been losing ground in crucial respects to many nations in the East, particularly, but not exclusively, to China. Major disparities in the rates of economic growth between East and West provide perhaps the most obvious evidence that this has been happening, but there are also many other ways in which countries in Southeast Asia have recently been pulling ahead of those in the West.

They are powering ahead in technology, particularly in cutting-edge areas such as Artificial Intelligence (AI) and biosciences. The World Economic Forum reports that, in 2016, a fairly typical year, graduations in STEM subjects (science, technology, engineering and maths) – providing the underpinning for future technical strength, economic and political power – numbered 4.7 million in China, 2.6 million in India and 568,000 in the USA.¹ In 2018, according to the Knoema World Atlas, 1,393,815 patents were applied for in China, 285,095 in the USA, 253,630 in Japan and no more than 46,617 in Germany.²

As the West's economic superiority has been challenged, western countries have become progressively less effective at using hard power, as the UK and France found at Suez in 1956, followed by comparable lack of success by western powers in Vietnam, Iraq, Libya, Syria and elsewhere – most recently in Afghanistan. The USA successfully faced down the USSR as the Cold War ended, but China looks like a much harder nut to crack. The recent clampdown on

democratic activity in Hong Kong showed China using brute force with near impunity. There is a threat to Taiwan which may turn out to be hard to handle, as may also be the build-up of Chinese bases in the South China Sea. China already has more naval ships than the USA. Currently, the Chinese vessels are, on average, much less powerful than those belonging to the Americans, but this is set to change by 2030 as a result of China's current massive naval shipbuilding programme.³

Turning to other telling factors, confidence in the future generally - and in their political leaders in particular - is considerably higher in the East than it is in the West. Many governments along the Pacific Rim now look more stable than some of those in Europe and North America, as populist discontent has destabilized politics in much of the West. The financial dependence of many western universities on charges to Chinese students has allowed them, under pressure from their home country, to use their influence to help to undermine already fragile rights to free speech. Many countries in the developing world, particularly in Africa, are becoming increasingly dependent on Chinese financial and technical support, rather than expecting help from western sources. Perhaps most fundamentally and critically of all, the precepts on which western civilization has been built are being shaken by the apparent inability of the West to run its affairs as competently as nations in the East seem to be doing. Some of them, particularly China, champion autocratic rather than democratic values and ideology. Liberal democracy does not look that impressive and appealing if it produces political stasis, inability to plan, inadequate investment, stagnant real incomes, aging and increasingly decrepit infrastructure, as well as ever widening wealth disparities.

The thesis in this book is that, while all these ways of considering why the West is slipping in relation to the East

are important, the most crucial underlying factor is relative economic performance. It is differential growth rates that have been responsible for the main disparities in outcomes and relative status, although the picture during the past few decades is mixed and some of it is remarkably inconsistent. Leadership in economic growth since World War II in the East has been essentially in two phases and the scale of the disparities of experience between them are so large that it is easy to overlook just how enormous they have been. Japan achieved a stunning rate of growth for several decades after World War II with gross domestic product (GDP) increasing by 8.8% cumulatively per annum between 1950 and 1976 and per head by 7.2% before both measures started to slow down dramatically, reaching a snail's pace from about 1990 onwards. China, by contrast, saw its GDP per head, starting from a low base, expanding by no more than 2.6% per annum cumulatively between 1950 and 1976, rather more slowly than the 3.6% average achieved over the same period across the West.⁴ Between 2000 and 2019, however, China's average GDP rose cumulatively by an average of 8.9% per annum and per head by 8.3%.⁵

It is when the cumulative impacts of differing growth rates of this magnitude are viewed not just over a year or two but across decades that their truly huge impact becomes apparent. Between 1950 and 1976, Japanese living standards rose to just over six times what they had been at the start of this period.⁶ By 2016, China's had increased to 4.6 what they had been in 1998, over only 18 years,⁷ while the rates of increase in the West were slipping. Japanese share of world trade was 1.4% in 1950 and 6.8% in 1970. By 1985 it was 9.4%, but since then the Japanese economy has stagnated, and by 2017 its world trade share had fallen back to 4.0%. China then took over setting the pace, with its share of world trade rising from 0.5% in 1970 to 13.2%

in 2017.⁸ This is what has driven the Chinese economy from producing 1.6% of world GDP in 1980 to 18.6% in 2020. Interestingly, because of China's sheer size, this ratio was as much as 17.2% in 1870, in a much poorer world.

This book is concerned with why these momentous changes took place. Why was it possible for the Japanese to do so well for 40 years after 1950 only for their growth rate to decline to barely 1% per annum for the next 30 years? Why was China able to move so rapidly from its relatively sluggish performance up to about 1980 to leaping ahead for the next four decades, with limited signs of its pace now slowing down very significantly. The Chinese economy is now set to overtake the USA in money GDP terms, having already done so on a purchasing power parity (PPP) basis early in the 2010s. Why, at the same time, has the West done so poorly? For the quarter century from 1950 to 1975, economic growth per annum in the West, in round figures, averaged about 4%. Between 1975 and 2000, it slipped to around 3%. For the first two decades of the twenty-first century, it dropped to an average of about 2%. In the 2020s, on present trends, once we recover from the coronavirus, we may be lucky to achieve a cumulative average of 1%.⁹

Why are western economies generally growing so slowly, compared to those in the East? Some of the reasons appear obvious, such as low levels of investment, although this begs the question as to why this was situation ever materialized. Other explanations do not stand up well to close investigation. It is not the case, for example, that high levels of GDP per head automatically entail lower growth rates. Singapore, with average living standards more than twice the western average, has seen its economy growing by a cumulative average of 5.2% in recent years. It is nevertheless true that investment in the future, as a percentage of GDP, is far lower in the West than it is in the

East. Against the background of a world average of 24.6%, for example, in 2016, the USA devoted 20.4% of its GDP to investment, the UK 16.9% and the Eurozone 20.3%. In China the ratio was 44.7% and in South Korea 28.9%. As the East's share of world trade has risen, the ratio for western economies has slumped - in the case of the USA, for example, from 18% in 1950 to 11.7% in 1985 and down to 8.9% by 2017¹⁰ - dragging the growth rate down with it, as we shall see. Why was this allowed to happen?

Why too have we in the West tolerated very large balance of payments deficits year after year in many countries - \$452 billion in 2016, a typical year for the USA,¹¹ and a peak that year of £108 billion in the UK - about 5% of UK GDP?¹² Why have we had to adopt Quantitative Easing policies in a not very effective attempt to generate more demand to keep consumption and employment up, but at the expense of debt creation on an industrial scale?

Misappropriation of financial resources is certainly not a problem exclusively found in the West, as Chinese bank lending practices show. Eastern economies, however, have managed to use financing of investment, manufacturing and export markets as drivers for their economies, whereas the West has relied more and more on consumption and debt. In the USA, in recent years, about 83% of GDP has been taken up by consumption, and 85% in the UK. In China it has been around 51% and in South Korea 65%.¹³

One approach to explaining the rapid growth rates in the East compared to the West is to treat them as being inevitable, or at least for it to have been impossible for the West to have done anything effective to stop these disparities materializing. The best that can then be achieved, it is argued, is to mould policymaking round making the best of a bad job and managing relative decline as well as we can. A key contention in this book is that this

inference is fundamentally incorrect. The West's unsuccessful record in competing with the East is not the consequence of ineluctable forces over which no one has – or could have had – any control. On the contrary, this book argues, we are where we are because of policy choices that could and should have been different. Furthermore, we could still shape the future in a much more positive and fruitful direction if we had the clarity of vision, the focus, and the determination to adopt and put into play better and more effective policies.

To help to find out what these changes might be, we need to look at the way in which economic policymaking has developed. What have been the dominant ideas that have influenced policy and how did they get there? What impact did they have on the outcomes which were produced? Why have many of them been so ineffective? Why did we watch Japan after World War II and China more recently achieving staggeringly high rates of economic growth even as we witnessed ours steadily declining without our policymakers apparently knowing what to do to enable the successes in the Far East to be replicated in the West?

Part of the answer lies in the deficiencies of academic economics, which has no satisfactorily settled view on what causes economic growth to take place and how it does so, and which has consequently failed to provide clear guidance to policymakers as to what to do to get the growth rate up. Since the early 1980s, economic thinking in the West has been dominated by monetarism and then neoliberalism. Rather than focusing on getting the economy to grow faster, priority has been given to fighting inflation and using market forces rather than government action to determine policy outcomes. Why has this happened? The remainder of this chapter provides an explanation, showing how attitudes to economics policy in the West have been conditioned by a different history, experience and outlook –

and intellectual power balance – to what has happened in the East. [Chapter 2](#) then traces the way the world's economic history has materialized since the start of the Industrial Revolution, to see how ideas about how to manage the economy evolved and what they led to in practice.

What light can thus be shed on our current predicament? What lessons can we learn and what policies should we adopt to improve our growth prospects? The conclusion is that, however important keeping inflation down to 2% per annum – or not much more than this – may be, it is overshadowed by the much more urgent need to get the West's economies to perform in a more balanced way and to grow faster. This is not just to enable us to compete more effectively with the East, important though this is. It is also to raise personal living standards, which is what people want. In addition, it is to provide resources to pay for all the challenges we have in prospect on climate change, rising health and social care costs, increasing pension commitments as our populations age and the need to train our workforces to deal with the huge changes that are in train. The conclusion is that we are going to need some radical alterations in policies if we are going to tackle reasonably successfully all the many problems with which we are currently confronted.

Whether by chance and happenstance or by design, the policies pursued by Japan up to about 1990, by China after it re-entered the world trading system around 1980, and by much of the rest of the Far East after the 1997 Asian crisis are clearly ones that have led to high growth rates. There is a consistent explanation running through this book as to how and why this happened. They were all achieved by high levels of investment, and the development of substantial manufacturing sectors with high productivity growth, driven by export competitiveness and buoyant

overseas demand. In much of the West, by contrast, the last 40 years have been characterized by deindustrialization, rising consumption as a percentage of GDP much of it financed by increased debt and balance of payments deficits. The key questions are why did the West ever let this happen and what could be done to stop these trends being maintained into the future?

Productivity and growth

It may be helpful to summarize at this stage in a little more detail what this book has to say about the way in which investment, productivity increases and economic growth interact with each other to produce widely varying growth rates. The conclusions reached then need to be tested against historical experience to see how well they account for what has happened. The argument goes as follows:

1. Economic growth stems mainly from physical rather than nontangible investment, with certain categories of expenditure playing a key role. In the absence of significant physical investment, increased productivity from supply-side sources, such as improved education and training, tax breaks, improved infrastructure, increased R&D and more readily available finance, rarely produce economic growth totalling more than perhaps 0.5% per annum – if as much as that – in slow-growing economies and 1% in those growing faster. Appropriate levels and types of physical investment are therefore key to the achievement and maintenance of a significant rate of economic growth.
2. Most types of physical investment, whether tangible or intangible, however, make only a small contribution to economic growth. This is the case for most public sector investment – in roads, rail, schools, hospitals,

public facilities and housing. The same applies to large amounts of private investment - in office blocks, shopping malls, most IT installations, and ventures such as new restaurants - and again housing. Certain key categories of investment, however, produce much higher-than-average total - or social - rates of return. These are clustered round mechanization, the application of technology and the use of power. It was the high returns from investment of these types which started to transform the world as the Industrial Revolution got under way, changing the way in which history unfolded from then onwards.

3. These higher rates of return take into account not only the private returns to whoever promoted and paid for the investments involved, but also all the other benefits that flow from them, which are diffused through the economy. These include higher wages and salaries, better and often cheaper products, a stronger tax base and the higher profitability made possible by the much increased productivity that the most productive forms of investment can generate, given appropriate demand and supply conditions. Whereas most kinds of physical investment produce total returns that are no higher on average than around historical market interest rates - perhaps 5% per annum - investments in mechanization, technology and power can - and often do, given the right conditions - produce social rates of return of 50% a year or more.
4. Whether economies grow fast or slowly therefore depends very largely on the proportion of their GDP that they spend on physical investment, but particularly on expenditure on the types that generate the highest social rates of return. These find their natural home mostly, though not exclusively, in the privately owned, internationally traded, light industrial sector. How

much investment then takes place depends on how profitable potential projects appear likely to be. It is making expenditure of this kind financially attractive that is the crucial key to increasing the proportion of GDP going into investment expenditure of all types, but especially of the most productive kind.

5. Getting this done in turn depends on two component factors, both of which are critical to competitiveness. One encompasses supply-side factors - the skills of the labour force, ease of access to finance, the state of the infrastructure, the quality of the legal system for resolving disputes, the enforceability of contracts, the lack of corruption, the presence of a fair and efficiently administered tax system, etc. The other is on the demand side and depends on the prices - determined by the exchange rate - at which the economy charges out all the domestically incurred costs on the production of the goods and services it offers to the rest of the world.
6. For any economy to be able to compete effectively in world markets, its exchange rate therefore must be set at a level which reflects the actual cost-effectiveness of its supply-side performance and the rate at which it is charged out. This is because these charges, once refracted through the exchange rate, determine the competitiveness at which these costs are expressed in export prices and the ability of domestic production to compete with imports. This is most effectively measured by the rate at which the economy's overall costs of labour are charged out, taking account of the productivity of its workforce - commonly referred to as relative unit labour costs.
7. If any country's exchange rate is so high that its export prices are on average uncompetitive on world markets,

it will lose its share of world trade. If it is below average, its share of world trade will increase. This contention, however, as is explained in more detail in the next chapter, depends on the price sensitivity - or elasticity of demand - for exports and imports being sufficiently large to meet the Marshall Lerner condition for a lower exchange rate improving the trade balance. This is that the sum of export and import elasticities is more than unity. Elasticities measure price sensitivity by determining to what extent decreased revenues from lower prices are compensated for by increased sales volumes. Meeting this condition is required to ensure that export demand is sufficiently increased by lower prices to avoid balance of payments constraints and to provide the stimulus needed to trigger export-led growth. Empirical evidence shows that - given the right demand and supply environment - this condition can be met almost anywhere, more particularly in the medium to long term, rather than the short term.

8. Exports of services are less price-sensitive than manufactures and some countries such as the UK have natural advantages that apply much more strongly to the production of services than physical goods - factors such as geography, language, the legal system, high-quality universities and labour skills. Most international trade is in visible goods rather than invisible services, however, and productivity improvements are much harder to achieve in services than they are in manufacturing. Countries that are very dependent on services rather than manufacturing therefore tend to grow relatively slowly, and to suffer from balance of payments weakness, because they are inclined to have insufficient value to sell abroad to pay for the imports they want to buy in.

9. Competitive export prices tend to lead to an increase in the share of world trade and the export-led boom conditions, thus tending in turn to generate high levels of investment and a burgeoning manufacturing sector with high productivity growth. The reverse applies to economies with falling shares of world trade. Countries with a rising share of world trade therefore almost invariably grow faster than those whose share is declining.
10. Typically for manufacturing, the costs of machinery, raw materials and components, for which there are world prices, comprise about 30% of total costs.¹⁴ The remaining 70% cover all local costs incurred in the domestic currency on wages and salaries, overhead costs interest and taxation. Buy-in costs incurred in international markets - for machinery, raw materials and components - stay the same in world currency terms whatever happens to the parity of the currency. By contrast, the rate at which all the domestically incurred costs are charged out to the rest of the world depends directly on the exchange rate.
11. It is therefore the exchange rate, more than anything else, which determines whether or not all the supply-side elements that make up what any economy has to offer to the rest of the world are offered at competitive prices. It therefore follows that ever since trade in manufactured goods became increasingly significant about 250 years ago, exchange rates have been crucial to determining which economies have expanded faster than the world average and which have grown more slowly, with all the implications thus brought in train for economic, military, political and ideological power, and influence.

A principal contention in this book is that academic economics, as taught in schools and universities, promulgated by think-tanks, and put into practice by policymakers, especially in the West, has not viewed economic policy in this way. Ever since the Industrial Revolution got into its stride towards the end of the eighteenth century, the study of economics has not considered nearly as much as it should have done the significance of exchange rates and the policies relating to them. Both theoretical economics and practical policymakers have assumed – especially since the advent of monetarism and neoliberalism – that the exchange rate is fixed by market forces, particularly capital movements, over which the authorities cannot have effective control, at least if combined with relatively free trading conditions. Competitiveness and trade balances, on this view, are therefore determined by market forces rather than by governments. Since existing rates cannot fruitfully be challenged, there is no point in having an exchange rate policy even though the implication is that prices – especially for manufactures – are not crucial to competitiveness in international markets, which is hardly a realistic stance. This book argues, on the contrary, that espousing an essentially hands-off policy approach to competitiveness has been a grievous error, one of whose major consequences – apart from much else – has been the eclipse for which the West is now suffering because of unmanageable competition from the Pacific Rim.

Economic theory

It is hard to avoid the conclusion that a good deal of the reason why we are not doing better than we are in the West in terms of economic growth is that economics as a subject has not developed along lines that have been as helpful

towards our policymakers as they might have been. Although expanding output at a reasonable rate is clearly a central policy goal for almost all governments, regardless of their political hue, economics as an intellectual discipline has never been as seriously orientated towards explaining what produces increased output as it has towards other matters, particularly how resources are allocated and existing output distributed, and how to control inflation and avoid unemployment. There is no generally accepted growth theory that explains how to get the growth rate up. What exists is much more descriptive than prescriptive. Economics has almost always been much more concerned with how the national income is divided up than it has been in making it larger. A brief history of the way economics has developed over the last 250 years provides the context.

Until the start of the Industrial Revolution, the main objective of economic policy, other than providing the state with sufficient funds for it to function and to pay for wars, was the accumulation of wealth, measured in gold and silver. It was Adam Smith (1723–90) in his *Wealth of Nations*, published in 1776, who – more than anyone else – persuaded the thinking world that the well-being of states depended essentially not on the accumulation of bullion but on the volume of goods and services that the economy produced every year, with markets playing a key role in making the economy satisfy human wants.

Adam Smith's most influential successors, David Ricardo (1772–1823), Thomas Malthus (1766–1834) and Jean-Baptiste Say (1767–1832), built on Smith's thought but with very mixed consequences for the progress of economics. In particular, Ricardo's ideas on the Labour Theory of Value, based on those of Adam Smith, failed to stand the test of time in explaining how prices were fixed while generating an anticapitalist bias – seized upon by Karl Marx – because they were unable to supply a

satisfactory explanation as to the contribution to output from entrepreneurial capitalists. Malthus, in turn, was mistaken about the inevitable immiseration of the working population as an unavoidable consequence of increased populations always exceeding rises in production, particularly of food. Say's theory that there could never be systematic underemployment of resources, including mass unemployment among the labour force, because demand always equalled supply, was not only proved wrong but also undermined the case for any kind of demand management by the government.

The consequence was a generally pessimistic view of the economic future, with little role for the state in creating conditions that might lead to the economy expanding faster and performing better. Even though, because of the Industrial Revolution, GDP in the UK had started increasing considerably faster from about 1750 onwards than it had done previously, there was little appreciation of the vast rises in living standards it was eventually capable of achieving. Perhaps this was partly because real blue-collar wages, particularly during the latter half of the eighteenth century, stagnated or fell, before they started to rise during the first half of the of the nineteenth century.¹⁵ The first major thinker who really appreciated anything like the full potential available from the Industrial Revolution was Karl Marx. The Communist Manifesto, published in 1848, declared that 'during its rule of scarce one hundred years [it] has created more massive and more colossal productive forces than have all preceding generations together'.¹⁶

As the nineteenth century progressed, economics had little to say about what we would now call macroeconomic policy even among such wide-ranging thinkers as John Stuart Mill (1806-73). On the continent of Europe - and in the USA - perhaps the most significant controversy was about the extent to which tariffs should be used to protect indigenous

industrialization. Generally, economics became increasingly concerned with microeconomic issues. The idea propounded more or less contemporaneously in the 1870s by William Stanley Jevons (1835–32), Karl Menger (1840–1921) and Léon Walras (1834–1910) on general equilibrium, with all prices being in balance at the margin, led to economics being treated increasingly as a science like physics or chemistry, with little or no normative content – and with correspondingly less impact on government policy. The most influential works, such as *Principles of Economics*, written by Alfred Marshall (1842–1924), first published in 1890, were much more concerned with supply and demand, marginal utility and the allocation of production costs than they were with macroeconomic policy. When the Great Depression struck at the end of the 1920s mainstream economics, because of this, had little to say about what should be done to counter the disastrous downturn in economic activity which the slump produced.

The huge levels of unemployment and output loss experienced at that time triggered a change in policy prescriptions, in which the UK economist John Maynard Keynes (1883–1946) was the leading figure. His key insight was that Say's theory was not correct. While the money value of demand and supply of goods and services for consumption might always be equal and therefore in balance, the same was not true of savings and investment. There might be chronic lack of demand if planned investment expenditure fell short of planned savings to finance it, unless expenditure by the state filled any gap that might be left. This opened a major role for the state in establishing conditions in which full employment ought to be possible – which was Keynes's main aim. His principal preoccupation was not with policies to produce higher rates of economic growth, although the policies he envisaged did achieve this objective, particularly in many

continental European countries and Japan, all of which grew very fast during the decades after World War II. Performances varied, however, with the UK economy's record, in particular, being rather less impressive, with an average annual growth rate between 1950 and 1970 of 2.8%, compared with 4.7% on the continent and 9.6% in Japan.¹⁷

Keynes himself was always sceptical about future growth. As stated in his *General Theory*, published in 1936, he believed that the marginal efficiency of capital - or the ability of advanced economies to find productive use for investment - was bound to decline in a wealthy community because, 'owing to its accumulation of capital being already large, the opportunities for further investment are less attractive'.¹⁸ Indeed, Keynes thought that a plateau in economic output would be reached before too many decades had passed, when economic growth had ceased, by which time he thought that most wants would have been satisfied. 'The economic problem', he wrote, 'is not - if we look into the future - the permanent problem of the human race.'¹⁹ The Keynesian revolution did not, therefore, provide the clarion call for domestic policies to achieve faster economic growth that is sometimes claimed.

Keynes also played a major role on the international stage in designing the international trading and monetary arrangements which were put in place at Bretton Woods at the end of World War II. Backed up by the International Monetary Fund (IMF) and the World Bank, world trade was to be liberalized within a framework of fixed exchange rates, tied through the US dollar to gold, which could only be altered with considerable difficulty. The result was that countries whose exchange rates were overvalued and that needed to get them down were pushed into deflation instead, while those with undervalued parities had little

incentive to see their currencies revalued to make them less competitive. The successful growth period for the West during the decades after World War II finished when the Bretton Woods system formally came to an end in August 1971 and the USA dissolved the link between gold at \$35 an ounce and the parity of the US dollar. The pressure for countries with overvalued currencies not to devalue remained, however, with a strong downwards influence on domestic and hence world growth rates emanating from the economies thus afflicted.

There followed an explosion in credit creation, followed by a sharp recession as inflation soared, exacerbated by a fourfold increase in the price of oil.²⁰ Very rapidly rising prices was a threat to which the Keynesian consensus had no effective response. The scene was then set for the arrival of monetarism, with its claim that it had a relatively simple and straightforward solution to the world's inflationary problem, with any impact it had on economic growth being subordinate to the battle against excessive price rises.

There was, however, a strand of economic thinking post-World War II that gave growth much more consideration. This was the theory, building on the Keynesian Harrod-Domar growth model, developed from the 1950s onwards by Robert Solow (b. 1924) and Trevor Swan (1918-89) and culminating in Solow's book *Growth Theory: An Exposition*, published in 1970. This posits a world in which growth initially is the product of labour and capital inputs, all of which have diminishing returns. Using existing technology, therefore, as countries get richer, they will inevitably move towards a steady state of output as the diminishing benefit from any increased investment becomes equal to the cost of depreciation. Economic growth from the use of existing additional labour or capital will then cease, leaving the