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THE CONDUCT OF MONETARY POLICY

By David T Llewellyn, based upon an address given at the ERC dinner on January 10th, 1990. Professor Llewellyn is Head of the Department of Economics, and Chairman of the Loughborough University Banking Centre.

In the Spring of 1988 the ERC sponsored a series of four public lectures by Professor Goodhart, Tim Congdon, Brian Reading and myself. These were subsequently brought together, plus contributions from four others, and a preface by Lord Ezra, and published by Macmillans in a volume: *Reflections on Money*[1]. The title well describes the content of the book and it is entirely appropriate that it was sponsored by the ERC given its enduring interest in issues related to money and credit, and the fact that over the 1980s there were major developments in monetary analysis and in the strategy and conduct of monetary policy. We hope these evolving issues are reflected in the volume though each chapter was written independently and each reflects the personal approach and views of the author: no attempt was made to impose any particular viewpoint. While the approach (frequently controversial) of each of the authors is personal, the common thread throughout is that issues related to money, credit and the conduct of monetary policy are crucially important in the economy. While none of the many controversies have been settled in the volume (that could never be our objective) we hope we have highlighted the major issues and in the process have contributed something of value to the on-going debate. It is, of course , for our readers to make the final judgement.

Money and its management has been a continuing topic of controversy over the centuries. Although old and basic controversies constantly re-emerge in increasingly sophisticated ways, the fundamental issues remain. Over the past two decades there have been major changes in each of four central dimensions:

1. **Theory**: views have developed substantially about how money is perceived, its creation and how monetary developments impact on the economy.
2. **Strategy**: there have been major changes in the monetary policy strategy: the type of strategy adopted, its relationship to fiscal policy, the role and choice of intermediate targets, and the time horizon adopted and in particular whether a medium term strategy is applied or whether discretionary short term changes are made in the conduct of monetary policy.
3. **Techniques**: There have also been significant changes in the instruments and techniques of monetary policy and the monetary policy operations of the bank of England. In general there has been a marked shift away from direct control mechanisms.
4. **Environment**: In addition, structural changes and financial innovation in the financial system have fundamentally changed the system environment in which monetary policy is conducted which amongst other things has made problematic the precise definition of "money".

1) Now available, price £14.99 from The ERC or from the Macmillan Press Tel: (0256) 29242

When these trends are combined a major difficulty emerges in our interpretation of the monetary policy experience of the 1980s. This may cause us to re-assess current pessimism about the precision of monetary policy in general and of control of the "money supply" in particular. A theme I wish to develop is that, while over the 1980s monetary policy became more central in the overall conduct of economic policy, the process of financial innovation and structural change in an increasingly competitive and de-regulated financial system also made for an exceptionally demanding environment in which to conduct monetary policy. It is ironic that the decade when the central role of monetary policy (and the control of the money supply) was increased, was also the period when changes in the financial system created one of the most difficult environments for the conduct of monetary policy. Given the nature of these changes, and the objectives set for monetary policy (i.e. reducing the rate of inflation from around 15% to less than 5%), it is difficult to imagine a more demanding environment for the effective conduct of monetary policy. This must be taken into account when making any assessment of the conduct of the monetary policy operations of the 1980s.

TARGETS

Of the many issues discussed in our book, I would like to focus on one of the central issues noted earlier: the role of targets in the conduct of monetary policy. A target is a variable that stands between the instruments of policy and the ultimate goal, and acts as a guide in the formulation of policy. Four main issues arise: (i) whether the efficiency of policy is enhanced with an intermediate target, (ii) what specific target should be adopted (most especially the choice between a money supply and exchange rate target); (iii) if an exchange rate target is adopted whether this should be as part of the EMS arrangement, and (iv) how dilemmas are resolved when pursuit of one target (e.g. the money supply) has consequences elsewhere (e.g. with the level of interest rates and the exchange rate) which are considered to be unacceptable.

The general case for adopting targets (most especially when the ultimate goal is to control the rate of inflation) is five-fold: (i) they may influence wage bargainers' behaviour to the extent that the Government's commitment to the target is credible and will induce a rise in unemployment if wage bargainers do not take this into account; (ii) to the extent that there is a predictable relationship between the target and the goal it serves as an advanced indicator of the goal variable; (iii) the commitment to a target serves as a disciplinary mechanism on Governments; (iv) it provides information to all agents in the economy about the future conduct of policy and thereby serves to reduce uncertainty in one important dimension, and (v) it acts as an "anchor" to inflation and inflation expectations.

Targets may be "implicit" or "explicit". In the former case a certain type of policy (e.g. the commitment to fixed exchange rates in the 1950s and 1960s) has the effect of a target even though it is not framed in this way. An explicit target, on the other hand, is established specifically to perform the role outlined above. There has been something of a cycle in Governments' attitudes to targets and five phases can be identified in the post-war period:

1. *1950s and 1960s*: an implicit target centred on the general commitment to fixed exchange rates.
2. *1970s*: No formal targets as the commitment to fixed exchanged rates was abandoned and, until the late 1970s, no alternative targets were adopted.
3. *1980–87*: this was the period with the most explicit and precise commitment to money supply targets centred on the medium term financial strategy (MTFS).
4. *1987–88*: the effective abandonment of money supply targets to be replaced by an informal commitment to an exchange rate target against the DM;
5. *Post 1988*: no clear commitment to any target with monetary policy conducted on a pragmatic basis by reference to a multitude of variables.

In general, periods when targets (implicit or explicit) have been adopted have also been periods of low or declining inflation rates though any statement about causality must be made with great caution.

In the context of inflation either an exchange rate or money supply target can serve as an anchor to inflation and inflation expectations. The fixed exchange rate regime of the 1950s and 1960s acted in this way although it was not necessarily viewed as such at the time. The obvious discipline of a fixed exchange rate is that "inflationary" wage settlements undermine competitiveness with direct consequences for employment. This is a particularly powerful mechanism when a non-inflationary policy is adopted by the key currency country in the system. The Bretton Woods system of exchange rates fixed against the US dollar broke down in the late 1960s and early 1970s when the US adopted an inflationary monetary policy. Conversely, the EMS has been successful largely because of the pivotal role of the Deutschmark and the policy independence of the Bundesbank with a strong and credible commitment to an anti-inflation monetary policy. In passing, one might ponder whether the EMS would survive if unification moves in Germany were to undermine the independence of the Bundesbank.

After the abandoning of fixed exchange rates, the 1970s saw a general evolution towards money supply targets in most industrial countries; they were first established in the UK in 1976. This culminated in the UK with the MTFS in 1979 which was the most explicit and precise formulation of monetary policy based upon money supply targets. Although in practice it did not operate as originally intended, the MTFS was to dominate economic policy for most of the 1980s. A medium term horizon was adopted for a precise set of publicly announced declining target ranges for a particular definition of the money supply. This was to be a clear signal to all agents in the economy and most especially to wage bargainers. At the same time, the commitment to a steady decline in the public sector's financial deficit meant that an attempt was made to achieve a degree of consistency between fiscal and monetary policy. The details of the MTFS, the way it was intended to work, the conditions required for it to work as originally intended, and why it was eventually abandoned are discussed in detail in various chapters of *Reflections on Money*.

The unambiguous objective of the MTFS was to reduce inflation and in this respect policy was clearly successful. However, this was achieved despite a spectacular failure to keep the chosen money supply concept (£M3) within the target ranges. In other words, £M3 seemed to be giving highly misleading signals about the true stance of monetary policy and it was ultimately for this reason that this version of the MTFS was abandoned. In our book, Chrystal believes that monetarism was not given a fair test. My own chapter argues that financial innovation and structural change in the financial system also undermined the efficiency of *any* money supply aggregate. This means that we should be cautious in making permanent judgement about the conduct of monetary policy, and its focus on the money supply in particular, based upon a decade of very substantial changes in the financial system which created a particularly demanding environment for the execution of monetary policy based upon money support targets. In general, it is not valid to apply evidence from a period of transition or stock-adjustment to one of a steady-state and more settled environment.

STRUCTURAL CHANGE

The 1980s was a decade of unprecedented financial innovation and structural change in the British financial system. It was a period of de-regulation, a greatly intensified competitive environment in the financial system, three major stock-adjustments (discussed below), the creation of new financial instruments, and major changes in the business objectives and operations of banks and other financial institutions. Altogether, and as many of these changes implied a sharp rise in credit and growth of the money supply, this created one of the most demanding environments that could be imagined for the successful execution of the monetary policy based on *precise* targets for *precise* concepts of the money supply!

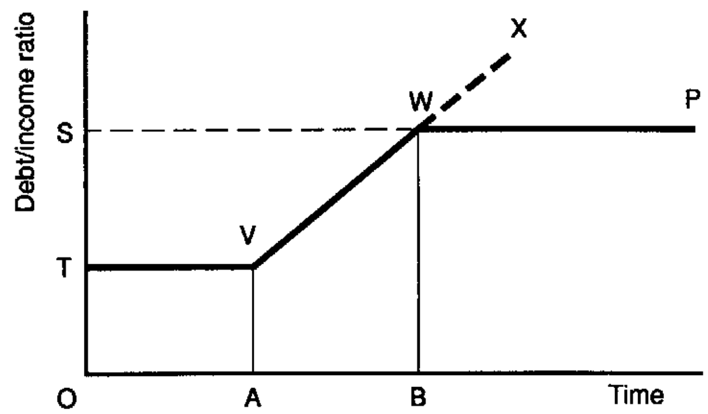
The various structural and operational changes in the financial system are well known and not repeated here though they are discussed in the book. They had major implications for the conduct of monetary policy not the least being that it became increasingly difficult to identify any unambiguous concept of "money". The distinction between different types of financial institution also became blurred and the uniqueness of banks was increasingly undermined. At the same time de-regulation changed the behaviour of financial institutions and while competitive pressures raised the efficiency of the financial system they also made it less responsive to monetary policy operations in the transitional phase.

Above all these processes also induced three major stock-adjustments: (i) a once-for-all shift from a "credit-constrained" to a "credit-free" financial system; (ii) a sharp rise in the value of personal sector wealth relative to income, and (iii) a very sharp rise in the personal sector's holding of equity in houses. Each of these meant that the 1980s was one of the most "credit-intensive" decades ever as the personal and company sectors made a substantial adjustment by increasing their stock of debt. Thus changes in the supply conditions of credit, coupled with a series of stock-adjustments on the demand side, meant that the volume of credit expanded at a substantial rate throughout the 1980s. At the same time and given the new types of bank accounts that became available, the rise in the holdings of "money" also partly reflected a switch in the form of holding savings rather than the accumulation of transactions balances. This meant that it was difficult to interpret trends in the money supply because the meaning attached to particular monetary aggregates changed over the decade in a way that

reduced the velocity of money. This could produce a declining trend in inflation while at the same time money supply aggregates were expanding at a much faster rate than envisaged in the MTFS.

ASSESSMENT

This raises difficult problems of interpretation. Some of the structural changes evident during the 1980s are of a stock-adjustment nature, i.e. reflect the movement from one type of structure to another. While the adjustment is taking place, the effect on credit and money, for example, can be substantial but it is not a continuing effect. For instance, I judge that for various reasons the personal sector implicitly made a portfolio switch to increase its stock of debt during the 1980s. The basic point can be illustrated in a very simple fashion in the figure below. In the period OA the desired target level of debt can be set at OT. However, if the target debt:income ratio rises to OS the period (AB) during which the stock-adjustment is made (the path VW) implies a strong rise in the volume of credit. But it does not continue at this pace (WX) but moderates (WP) once the new target level has been achieved.



My point is that during the 1980s there were a series of simultaneous stock-adjustments all of which had the effect of creating a transitory sharp rise in both the volume of credit and stock of money balances. I judge that, during such a phase of stock-adjustment, involving changes in the behaviour of both the suppliers and demanders of credit, there is very little that a feasible monetary policy could do to control the growth of credit and money. The countervailing, albeit partly transitory, forces were simply too powerful.

This does not necessarily mean that the conduct of monetary policy is permanently undermined. Rather it means that we should not expect steady-state conditions to prevail during a prolonged phase of stock adjustment. It also means that the conduct and interpretation of monetary policy cannot be divorced from its institutional environment. Above all in a phase of structural change in the financial system there is no single, unambiguous concept of "money" that can perform the exclusive role of acting as a target of policy. This does not discredit or undermine the long run conduct of monetary policy in a more settled environment, and once the stock-adjustments have been completed.

It is ironic that the heaviest demands on monetary policy were established during a decade when, because of a series of structural changes in the financial system, the environment was exceptionally demanding. It may prove to be that we have become unnecessarily pessimistic about the role of money supply targets because of the experience of the 1980s. It may be that they have become discredited because the test that was conducted was made in a decade in which they had little chance to succeed. Some of the changes in the financial system (particularly competitive conditions) are permanent and will always pose difficulties in the conduct of monetary policy. However, we should certainly be careful how we interpret the experience of the 1980s for I believe it will prove to be a quite exceptional decade.

CORPORATION TAX – THE CAUSE OF INFLATION?

By Mr G.W. Gardiner

A new tax

In April 1965 James Callaghan as Chancellor of the Exchequer introduced corporation tax to Britain. He applied the "classical" form of corporation tax: that is a tax on company profits which is additional to any income tax on the dividends paid by the company. It was argued that corporation tax was a more modern tax, that it would enable companies to be taxed at a lower rate than individuals, and that it would motivate companies to retain and reinvest a higher proportion of their profits.

A few days later France abandoned the classical form of corporation tax, thereby casting doubt on its "modernity". Corporation tax has never been levied at a lower rate than the standard rate of income tax, and the proportion of profits retained by companies fell from 44.82% in 1965 to 31.97% in 1969. In real terms the fall in retentions was even greater as inflation doubled between 1965 and 1969 and much of the profit retention in 1969 and after was truly additional depreciation.

Inflation appears

Inflation stated to grow as soon as corporation tax became fully effective.

Year	1966	1967	1968	1969	1970	1971	1972
% Inflation rate	3	2.9	4.73	5.64	6.8	8.6	7.55

(Calculated from National Income Blue Book 1973, Table 16: Index of prices of all final goods and services sold on the home market).

The inflation rate measures what should be termed kinetic inflation, on the analogy of kinetic energy. There is also potential inflation, which is inflation that has already been caused, but whose appearance in the statistics is prevented either by consumer subsidies or by an artificially bolstered exchange rate which keeps import prices low. Bolstering was in operation in 1967 and therefore some of the inflation of 1968 and 1969 properly relates to the period before the 14% devaluation of November 1967.

Although there are always many factors at work in the causation of any inflation I believe that in the specific environment of the British capital market it is justifiable to believe there was some causal relationship between the upward trend of inflation after 1965 and the introduction of corporation tax.

The encouragement of debt capital

Corporation tax cheapened debt capital relative to equity because a net of tax dividend on equity required about 1.8 times more earnings to service it than the equivalent net interest payment on a loan. The consequence of the tax change on new issues was that in the period 1959–64 58.7% of new company finance was equity whereas in the period 1965–70 it fell to 27.1%.

The collapse of Rolls-Royce in 1971 was attributed partly to its reliance on loan capital, and in an article on corporation tax in that year I pointed out that five of its seven fixed interest issues had been raised after the introduction of corporation tax, and I warned that, "If an economic slump takes place, many companies which could survive if all their capital had been equity are forced into liquidation." Ten years later this point was amply demonstrated.

Fixed interest issues unwanted ...

Professional investors were increasingly reluctant to invest in fixed interest capital. They had grown very conscious of the effects of inflation and no longer regarded fixed interest issues as "safe" investments. Ordinary shares had come back into favour in 1953 and the "cult of the equity" had by 1965 reversed the traditional yield relationship of fixed interest issues and equities. No sensible investor wanted large holdings of fixed interest stocks, and the less sensible investors were attracted only by the consequent high yields on such stocks. Before corporation tax the best British companies had been able to capitalise themselves with equity at very low cost, 3% dividend yields being acceptable for rights issues. I was concerned with the management of trust funds from 1956 to 1983 and because of my fear of inflation I discouraged investment in gilts, preference shares, building societies, and mortgages. I prophesied that some day a trust corporation would be sued for damages for having invested trust money in gilts. The case of *Nestle v. National Westminster Bank 1984*, fulfilled that prophecy and the defendant won the case only because a high proportion of equities had been retained in the trust, even in the deflationary period of the twenties and early thirties. But an expert witness for the plaintiff had gone so far as to maintain that there should have been no fixed interest investment though the period of the trust, which started in 1922.

... except by non-professional investors

Although the professional investor did not want to invest in debt capital, the public was still happy to do so as the progress of the building society movement showed. Indeed inflation may increase the public's preference for liquid assets even though economic theory says one should buy equity assets in an inflationary period. Japan, which had experienced inflation as a result of losing the war, had recognised this phenomenon and in the early 1950s provided avenues by which the public's savings could be channelled into debt capital for industry. The avenues were Money Trusts and Loan Trusts. The public happily deposited money in Loan Trusts for fixed terms of two or five years, and on the basis of these deposits medium term loans were provided for industry and could be readily rolled over at maturity because of the medium term nature of the deposits that financed them. A manager of a Japanese Trust bank told me that 95% of its deposits were for five years.

Loan Trusts were ideal partners for a classical corporation tax system and should have been promoted alongside it in Britain. In 1974 I made a study of the possibility of promoting such a form of saving in Britain. I found the idea stymied by two hindrances. Amazingly one was that corporation tax would have been applied to the income of the loan trust, preventing a competitive yield being offered to investors; secondly there was no hope of competing with the building societies which then not only benefited from favourable tax treatment but were also allowed to lend for twenty-five years, or even more, money which was callable at a few days' notice. In such an environment there was no hope of success for a British lending institution that virtuously matched the maturity of assets and liabilities.

Interest rates rise!

Following the introduction of corporation tax the increasing demand for loans and the reluctance of depositors to lend at low interst rates caused interest rates on loans and debentures to rise. In the early days of Japan's surge of economic growth bank loans at 9% were common but when a prominent British company issued a debenture with a coupon of 9% there was consternation. On the day of the announcement I lunched with the Fellows of Christ's College Cambridge, one of whom asked me what I thought of this development. After explaining that it was an inevitable result of the introduction of corporation tax I added that if the pattern of equity yields remained as it was then the interest rate on industrial loan stocks would rise to 14%. Startled silence met my comment, but I thought I detected a faint smile of confirmation on the normally undemonstrative face of Professor James Meade who was later to be a critic of the tax as well as a winner of the Nobel Prize. My prophecy was fulfilled.

The rise in interest rates increased the government's borrowing costs, and therefore made it necessary to increase taxation. The rate of corporation tax was therefore raised, a move which had the effect of increasing the rate of interest that a company would be prepared to pay rather than resort to an equity issue. In 1970 industrial and commercial companies raised only £39 million on equity capital, compared with over £1200 million borrowed from banks.

The effect of corporation tax was upon the longer end of the interest yield curve, but the shorter end of the curve was dragged up by the necessity, consequent upon rising inflation, to bolster the exchange rate. To avoid devaluation the Bank of England raised Bank Rate to 8%, a level which would not nowadays seem high but caused a sensation then, for it was 3% higher than the rate which was used in 1925 to get sterling on to the gold standard at an excessive valuation, and 1% higher than that during the crisis that followed the Suez war. Such was the transformation in interest rates triggered by the introduction of corporation tax.

High interest rates cause inflation

The 1960's provided no empirical proof of the theory that high interest rates reduce inflation. That should cause no surprise for high interest rates are more likely to cause inflation than cure it. The idea that they cure inflation rests on two arguments. The first argument is that high interest rates discourage borrowing and thus restrain the expansion of the money supply. Secondly it is argued that high interest rates cause recession and unemployment which act as a brake on wage claims which are the main cause of cost inflation. I concede that the second argument can be true, especially when the effect of high interest rates is to overvalue the currency, but I feel sympathy with J.M. Keynes' comment that it is "neither just nor humane" to use unemployment as a weapon of credit control.

But there are many more arguments in favour of the contention that high interest rates *cause* inflation. High interest rates increase unit costs and therefore cause cost inflation. If they are effective in causing recession that means shorter production runs which also raise unit costs. Recession leads to greater expenditure on unemployment benefits which can translate into higher costs.

But the most effective reason is the fact that in Britain high interest rates immediately raise the cost of servicing mortgages. The unorthodox British system of financing housing loans with short term deposits enables them to be charged short term interest rates. At one time this seemed brilliantly clever as mortgagors paid only 4% interest. But when the government put into execution the theory that high interest rates cure inflation interest rates not only rose but could be higher for short term money than for long. This was a severe blow to mortgagors, most of whom are economically active young wage earners. Hit by high interest rates, which transfer purchasing power from the young to the old because wealth ownership increases exponentially with age, the young fight back with unrelenting demands for higher wages – and they get them. Moreover the annual round of wage rises becomes an established habit and wage cost inflation becomes endemic. Many mortgagors are intelligent enough to see that inflation favours debtors and they actively encourage it. They are told that inflation will cause unemployment, but they are unconvinced. It can indeed be argued that it is the foolish things that are done in reaction to inflation that cause unemployment, not inflation itself, which as post war history has shown can be a spur to economic growth.

In other countries mortgagors can still borrow at a fixed rate, not a variable rate of interest, and therefore a rise in interest rates does not immediately stimulate wage inflation. Instead in America an increase in interest rates bankrupted the Savings and Loan Associations. **In Britain high interest rates made the lending institutions highly profitable.**

An error by Lord Keynes

In the 1930s under the influence of J.M. Keynes the theory that low interest rates would cause the money supply to expand, that a multiplier effect would follow, and that the economy would consequently expand, was put to the test. Bank Rate bottomed at 2% in 1932 where it was to remain, but for a brief interlude in 1939, until November 1951. After an initial surge after 1931 the economy slowed. Why?

One reason is that the underlying theory ignores the fact that there is a relationship between the two sides of a bank's balance sheet. That relationship is very simple: *the two sides add up to the same figure*. To expand the assets side (i.e. lending) of a bank's balance sheet it is also necessary to expand the liabilities side (i.e. deposits). Although the drawing down of a loan automatically creates a deposit somewhere in the banking system to balance the loan, to maintain the liabilities side of the balance sheet at the higher level, high interest rates must be helpful. **In Keynesian jargon the expansion of the money supply requires an increased propensity to hold deposits as well as an increased propensity to borrow. The traditional theory about the effects of high interest rates can thus be stood on its head, and the empirical evidence seems to suggest that for a sustained expansion of the money supply high interest rates are a prerequisite, not a hindrance.**

Low interest rates destroy the profits of banks

Another reason is that with low interest rates there is little profit in banking. Just how low the profits of the banks were in the low interest rate era is not known as true banking profits were then secret. Popular imagination enhanced them enormously but an authoritative source convinced me that the banks were in real trouble as late as the early 1950s. If banking is not profitable banks can neither attract new capital nor plough back profits in order to increase their capital bases. If they cannot get new capital they cannot expand their lendings because they need a reserve that is related to the amount of their liabilities, currently 8%. If they cannot raise additional capital they cannot expand the money supply, and the only way they can then assist inflation is to persuade some customers to fund their debts which releases part of the capital base for the creation of new credit.

In fact in Britain ultra low interest rates appear to be a way of reducing inflation and of stifling economic growth.

High interest rates make banking profits rise

Corporation tax caused interest rates to rise and thus made banking very profitable, and capital raising exercises by banks became more and more frequent. The high level of bank profits prompted in 1974 a Labour Party election poster which read "Bank Robs

Takeover Bids and Short Termism

The Need for a New Balance when British Management Faces Europe and the City Across the Hostile Bid Table.

By Peter Rodgers, Financial Editor, The Independent*

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** Based on a talk given to Members of the Economic Research Council on 7th February.*

Alarm bells

I would like to talk about takeover bids and short termism because I believe they are about to become a political issue again. British industry remains extraordinarily open to overseas bidders. European industry is restructuring. But for the UK it remains very much a one way street. Though bid fever has died away a little, there are very good reasons for seeing 1992 and all that as a spur both to bids from the EC and from other countries looking for a Euro-foothold.

I have built up a thick file of letters from company chairmen on the iniquities of Britain's free market in corporate control. Most were written just before their companies went down for the third time, in the face of a hostile bid. But the arguments which interest shareholders are usually price and price and price, not the underlying merits of this kind of activity.

Last spring I listened to an extraordinary performance by Sir James Goldsmith which rather alarmed me. He proposed a motion in favour of hostile bids at a debate organised on Oxford Union lines at the Bank of England, and chaired by the Governor.

Not surprisingly, Goldsmith listed dozens of pieces of US research purporting to show the economic benefits of hostile takeovers – particularly his own 3 successful US efforts. I cannot whether Patrick Sheehy was in the audience of the great and good. Come what may, you will have seen all Goldsmith's views about "liberating managements" in the BAT's bid. But it wasn't what he said which was surprising – he would say that before a £13 billion bid. It was the fact that he won the vote overwhelmingly. The audience was dominated by industrialists, who mostly seemed to agree with Goldsmith, even though many might have been his next target. Perhaps they all saw themselves as predators not prey.

Certainly, the bid culture is endemic. I found it pretty easy to join the minority that voted against Goldsmith but I still wonder why it was so small. The problem is that knocking down his case in a rigorous way proved a lot more difficult than I expected.

Historical perspective

First, a historical perspective. It is a fact that mergers have had a bad press among economists for a very long time. For , instance, Martin Wiener says in English Culture and the Decline of the Industrial Spirit, "The characteristic change that British firms made under pressure of international competition was amalgamation – but not, like many of the similar moves in America, as a springboard to new possibilities of growth.... Starting with the mergers of the 1890s, many British amalgamations were 'desperate and half-hearted alliances apparently motivated more by a desire to preserve the status quo than to tackle markets more aggressively.'" An example was the 1902 merger of Stewart & Menzies and Lloyd & Lloyd expressly for the purpose of the "extinction of competition."

There was a wider consensus, too. Most big businesses and their organisations such as the Federation of British Industries saw restrictive practices as "humane guarantees of regular employment at higher wages for working people." This anti-competitive

attitude began to change slowly after the war, with the 1948 Monopolies and Restrictive Practices Act, the 1956 Restrictive Practices Act, the 1965 Monopolies and Mergers Act and the abolition of resale price maintenance. Competition appeared to have won as a philosophy, and there was a more sceptical view of the benefits of mergers. But it was short lived, and even illusory.

Labour became deeply involved on promoting and subsidising concentrating in industry, creating national champions able to stand up to giant foreign firms. Heath soon came round to a similar policy. On the one hand, these were billed as long overdue modernisations. On the other we known from the results – the motor industry, consumer electronics – that they were nothing of the sort. They were not, as in the 1890s undertaken with the sole purpose of preserving the status quo – though there were pure job preservation exceptions, such as Upper Clyde Shipbuilders. But other countries developed national champions much more successfully. Perhaps the UK was simply not good enough at it, because of all those well documented educational, managerial and cultural deficiencies. A policy designed to modernise through corporate strength, technology and investment fell into disrepute when people looked at the results of the mergers which were its instruments.

Private industry also saw a great merger binge at much the same period, and with similarly disappointing results. There was a lot of academic research in the 1970s and 1980s which confirms this, and though there are doubts about the methodologies the general thrust is probably right because of the level of agreement. Nine studies cited by the DTI's 1988 blue paper on merger policy, including four published as 1986, found the results of mergers disappointing or inconclusive – and that even includes share price performance.

The conclusion is that state and private enterprise inspired mergers and takeover are neutral or harmful – so get lost Goldsmith. Unfortunately it is not as simple as that. The counter-case, which is highly political and is the one that matters for the latest merger boom, was best put by a merchant banker friend, who said simply, "You are out of date."

Of course, those 1960s and 1970s mergers showed inconclusive results. They were the last wave of a process that began in Victorian times, a drive towards management security and lowering of competitive pressures, a defensive outlook on life. It was all so cosy, whether state inspired or not, that you would not expect benefits to show up in the research. Of course the results are negative. But the 1980s merger boom was different, he says: under Mrs Thatcher, the culture has changed. Takeovers, agreed or hostile, used to reinforce an inefficient industrial system. Now they perform the function they should have had, by replacing poor managements with better ones.

So he says when we see the result of 1990s research into the 1980s merger boom it will tell an entirely different story, more in tune with the US economic evidence cited by Goldsmith (though he was being partial: there are plenty of American academics who have said exactly the opposite).

But more important than this special pleading is the fact that the statement rests – at this moment – on faith rather than evidence. Could it conceivably be true? Or does it resemble the early version of the Government's monetary policy, when we were told to believe in sterling M_3 because Sir Keith Joseph did, and never mind the evidence? If the latter is true, current British merger policy may turn out to be yet another experiment carried out on the economy with unforeseeable results.

The Government's stance takes the merchant banker's argument a stage further. It goes like this: European takeover activity is decades behind Britain's and hostile bids are virtually unknown. We have a free market in corporate control based on much more open stock markets than in Europe (or Japan) and a rigorous restriction of controls to questions of competition (except, it has to be said, where banking and defence are concerned).

We believe strongly that this state of affairs is so good for the British economy that we will do nothing to restrict foreign bidders. Instead, we will press Europe to open up and allow us in. That may take a long time. But never mind the risk of foreign control of British industry: if they want to curb the free market in corporate control they will suffer for it. They will not win the huge benefits we believe (but cannot yet prove) that it brings to the UK.

There is another argument, that as the largest foreign acquirer in the US, how can we preach restriction? To deal with that first, I don't believe we can preach it where the US is concerned. But both the US and UK markets are relatively open. The difficulty is Europe, and perhaps eventually Japan.

4 out of 5 EEC takeovers happen in the U.K.

Europe is the key at the moment. My principle text on this is provided by the DTI itself, price £200. It is called Barriers to Takeovers in the European Community, a report by Coopers & Lybrand, commissioned by the DTI and published in December. What the three volumes of the report catalogue at great length is how 4 out of every 5 takeovers in the EC happen in the UK. In every other EC country there are huge barriers, more cultural than legislative, to takeover and particularly the hostile ones.

The reports says "It is apparent from the available statistical data that the capital markets in the UK are more conducive to cross-border amalgamations than are the capital markets in EC countries." This applies both to finance for acquisitions and to the openness of large quoted UK companies to domestic or foreign buyers.

Examples:

Italy: over 200 listed companies, only 7 have 50 per cent of shares in public hands and 5 of those are effectively controlled by family groupings.

Germany: extensive long term bank shareholdings concentrate control; many quoted companies have only a minority of shares in public hands; many technical barriers to takeovers e.g. 2 tier boards which lead to delay in changing management boards. (In the Netherlands there are no powers in many cases for shareholders to change either board.) In West Germany there have only been two recent hostile bids, one by Robert Maxwell, and both failed.

France: over half the largest 200 companies are family controlled & given the extent of

Government shareholdings and across shareholdings a substantial number of quoted companies appear to be immune from bids.

Spain: shareholdings are not even disclosed. Bank, family and cross shareholdings are major barriers to a contested bid for most companies.

My favourite passage is the following, in a description of cultural and technical barriers to takeovers in Germany and the Netherlands:

> "To someone steeped in the UK culture, of management being accountable primarily to shareholders and being judged essentially in value terms (shareholder value), these defences appear unethical and designed to maintain the interests of the existing management group. However, in the absence of that cultural background opinion in these countries can tend to regard the possibility of "predators" seizing control of companies, without regard to the interests of the companies, as itself being quite unethical."
>
> *or*
>
> "The business culture and ethics of accountability and relatively free disclosure prevalent in the UK are generally seen as being one extreme of that diversity rather than norm."
>
> *and*
>
> "In order to seek to remove such barriers, it may be necessary to force a change of opinion on this cultural point."

That sounds to me like a very long job – making European business culture Anglo-Saxon. The report makes it clear that in most countries cultural barriers are the key (for example Italy) but where they begin to weaken technical barriers soon begin to replace them (e.g. Netherlands, Germany). They won't let go easily.

The relatively small numbers of mergers in Europe are almost all agreed. Some argue that while the UK is criticised for having a greater proportion of hostile bids they are still a minority, with agreed bids the usual practice – thus putting us more in line with continental practice. The Pru, for instance, says it backs few hostile bids.

But in an open stock market it is a dangerous oversimplification to separate agreed and hostile bids. As the report says, it ignores the pressures that can be put on management to consider agreeing a deal, while management also has to consider the possibility that the would-be bidder might put an offer directly to shareholders.

And of course there is the simple fact that 4 out of 5 EC takeovers happen in the UK. It is a different order of magnitude. European Deal Review said recently that the UK was by far the most popular international target in Europe, with European deals in the UK twice as valuable as the reverse flow (and also three quarters of US acquisitions in the EC are made in the UK).

U.K. Government philosophy

Now you might see this as alarming, or at least a warning. But the Government takes, in my view, a perverse view of the findings. The Corporate Affairs Minister John Redwood says in his introduction: "The Government is keen to secure the removal of unnecessary barriers to takeover throughout the EC and to extend the benefits of open and efficient markets throughout the community." In other words, we are urging the EC Commission to create a level playing field – on our level. In the meantime we will not tinker with our system.

Given how entrenched European practices are, I think this is hopelessly Panglossian, and this is beginning to sink in at Westminster. Whatever you believe about the relevance of academic research on the effectiveness of mergers, there is one outstanding point: an utterly unfree market in corporate control throughout the rest of Europe has not prevented other economies overtaking and far surpassing ours. The Government claims we have been among the fastest growing since 1981 (not 1979) but our recent growth rates are at levels far below the longer term post war averages for Europe. The trade deficit doesn't augur well for our relative growth prospects over the next few years, as well.

So on the one hand you have Ridley's predecessor Lord Young claiming (in private at least) that Europe is now suffering the malaise Britain experienced in the 70s, so we carry the flame of free markets to them before they totally disintegrate. On the other, you have the UK facing a new set of economic problems with unpleasant overtones of the 1970s, and what looks suspiciously like the opportunity for an international raid on British business. We can return the compliments in the US, and have done so, but cannot in Europe, at least to anything like the same extent.

An assessment

I am not against takeover in principle or in practice, because they do often serve a useful purpose. But I am fairly sure that the balance has tipped too far in the direction of making life easy for anyone who wants to bid for a UK company. There are companies that deserve to be taken over (e.g. Distillers) and others such as DRG, the paper group, where a takeover is pure financial manoeuvring.

This point is close to that hoary old debate short termism and the City. I know the CBI had a great investigation a couple of years ago which came up with the momentous conclusion that there was no such thing as short termism, only a lack of communication. I think that was rubbish. In daily experience, I keep meeting short termism. There are fund managers obsessed by results and quarterly performance records. There is clever financing that generates huge fees with little regard to the consequences for the company being bought (whether by another firm or its management). Look at Magnet. There is also the complete abdication of the Government from any ideas, let alone strategies, in important industrial sectors which are treated very seriously elsewhere.

All three were summed up by Sir William Barlow, BICC chairman and former Post Office and Ransome Hoffman Pollard chairman, in a letter to the Financial Times

recently about RHP, the ballbearing manufacturer, which was formed 20 years ago to avoid a Swedish takeover, renamed UPI in a management buyout 2 years ago and has just been sold to NSK, the Japanese bearing maker.

He says "With a deplorable lack of patience, the financial institutions and venture capitalists have taken a fat profit only 2 years after launching UPI. As a result, management shareholders will receive cash beyond their dreams and retain their jobs, at least for the time being. The City will doubtless regard this as a successful financial foray. Our financial institutions often claim they are real investors but many cannot resist the temptation of short term gain, and industry cannot rely on their loyalty."

I have a private letter here from the chairman of another large company who says "In the 70s, British management, with some justification, could argue that the power of the unions monopolised strategic thinking. In the 80s, the equivalent bogeyman is the predatory bidder." He concluded that the only real beneficiaries from the UK attitude towards takeovers are the "fee collectors" in the City.

Management's reaction to the culture in which it operates is to be obsessed with short term earnings performance, against long term planning. Now whenever that is said in the City the retort is that there is no evidence whatsoever. But I find all the time that is the way many business managers talk. The values of the City have crept in everywhere, as they did when so many industrialists voted for Goldsmith at the debate.

The majority of firms apparently sees no problems in this area and the CBI backed down from demands to change the takeover rules in favour of sitting managements. But perhaps the culture is now so widespread that any top manager worth his salt has to make bids of his own, either to prevent someone doing it to him, or to disguise his own company's inability to grow organically, or just to make himself feel better. Some conglomerates that buy and sell companies do contribute to the businesses, their shareholders and the economy, by performing the ideal function of improving efficiency. But that does not apply to many, especially in the feverish condition of the last few years.

Unless I am proved wrong, and some researchers show me that the mergers of the 80s are any more effective than those of the 60s and 70s, then most of the bids of the last few years will prove an expensive waste of effort from the point of view of both companies, shareholders and the economy, but very good for the earnings of the financial services sector.

Policies for internal growth

What can be done? I don't want to revert to sweeping Government set criteria for mergers (Rover again) or to a block on hostile bids. But I think there is a good case for shifting the balance of power a few notches away from the predator, and also for being a bit more realistic about takeovers from Europe if there is no practical reciprocity. (The Government sticks to whether there is legal reciprocity which is almost irrelevant where barriers to takeovers are either cultural or specifically approved by shareholders).

Even with existing powers, there is nothing to stop routine examination of highly leveraged or junk deals, such as BAT or DRG. At present, these are only referred if the leveraging risks damaging competition, rather than the company. Single minded concentration on competition as a criterion is a political decision, and it favours conglomerate builders.

What we also need to do is to put a much greater burden of proof on the bidder's side – not just some vague public interest criterion. We need a positive demonstration that competitiveness will be improved in a number of defined areas – R&D, marketing, and production and marketing efficiencies – as well as proof that competition in the market place will not be damaged.

There are tremendous strengths in internal growth. Who now remembers that Beecham once nearly bought Glaxo? What a disaster that would have been. Now Beecham slinks off in a doubtful protective alliance with SKF, while Glaxo grew its own drugs and is enormous. What about the retailing dinosaur, Storehouse, assembled through bids and falling apart ever since? I could go on.

Bidders, the Stock Exchange, the Takeover Panel and shareholders all claim speed is vital in resolving bids, and up to a point uncertainty is extremely damaging and expensive. Well I say that any bid whose logic cannot survive a three or six month wait cannot be very well based. I would argue that a longer wait is often in everyone's interest, and even shareholders will benefit in the long run if they take the performance of their entire portfolios into account.

The vast majority of decisions is made not at the MMC but at the OFT which has tried to accommodate itself to the City by giving speedy decisions. But delay caused by a more rigorous examination on a number of defined public interest grounds might simply cause the more opportunist and inefficient bids to fade away.

Reciprocracy of opportunity

This is of course bound up with Europe, and the EC's takeover of merger controls where large companies are concerned, which is a bit of a minefield. But if the German Cartel Office can hold out for a position more suited to local needs, so can we.

Perhaps the simplest answer is before our eyes, in the City takeover code, which is non-statutory. This works reasonably well (except at catching liars and cheats). But I cannot understand why there is so much resistance to lowering bid thresholds and further increasing transparency, or even lengthening the timetable.

The alternative to erecting our own informal barriers where we are forced to, and shifting the balance just a little bit against bidders, is to find ownership of a lot of British industry moving abroad in the next five years, while European companies sit safely behind the walls they have erected for themselves. In fact I find the Government attitude rather touching. It is slammed for being anti-European yet in takeover practice it is being such a loyal upstanding member of the EC that we end up getting rolled over by our competitors.

I believe reciprocity of opportunity is a basic principle. Countries are out to win, companies are out to win, and there is no point opening doors to competitors who slam them in your face.

Appendix

Post-merger performance: the evidence

I. Introduction

1. The 1978 Green Paper (Cmnd 7198) considered several studies that attempted to evaluate the benefit mergers by looking at post-merger profitability in comparison with profitability before the mergers took place. These studies produced the finding that in roughly half the cases examined, the merger had resulted in an unfavourable or neutral effect on the profitability of the companies concerned. The failure of the evidence to show improved profitability following mergers was interpreted as strong evidence that mergers were failing to generate economic benefits.

2. It was recognised that there were a number of limitations to those studies of post-merger performance. In particular, there were difficulties in estimating how the firms concerned would have performed in the absence of the merger and thus in attributing any change in profitability to the merger itself. The force of this criticism was reduced by the fact that other studies adopting quite different approaches had arrived at results similarly showing disappointing post-merger performance. A further problems with the studies is that they measure performance by profitability, a weak test of efficiency gains because mergers may produce higher profits through the exploitation of increased market power. Thus this limitation serves, if anything, to reinforce the findings of poor post-merger performance.

II. Subsequent evidence

3. Since Cmnd 7198 was prepared, a number of empirical studies of merger performance have been conducted using several approaches. These include detailed case studies, accounting studies of pre- and post-merger performance and stock market studies that assess whether mergers create value for shareholders. The findings of a number of these studies are summarised below:

a) Cowling (1980). Using an in-depth case study approach of nine mergers that occurred between 1965 and 1970, this attempts to assess the overall contribution of mergers to economic efficiency of firms, thus avoiding the shortcomings associated with profit performance. Efficiency was measured using the unit factor requirement index that estimates total input requirements per unit of output. The results showed no general efficiency gains forthcoming. However, there were one or two instances of efficiency gains, notably when superior management gained control of more resources, but these were not sufficient to suggest that efficiency gains typically apply.

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1 Annex to the Department of Trade & Industry Blue Paper on Merger Policy 1988.

b) Mueller et al (1980). This major empirical investigation was designed as an international comparison covering seven countries-UK, USA, Germany, France, Belgium, Holland and Sweden. One of the objectives of the research was to ascertain whether mergers increased the efficiency of the companies concerned. This also recognised the inadequacy of the profit test and measured performance using growth and share prices as well as profitability. The results using after-tax profits were mixed, with four countries, including the UK, showing slightly improved performance and the other three showing declines. The tests on growth were uniformly negative. Returns to shareholders in four countries including the UK, improved in the immediate post-merger period, but this difference disappeared after three years. The results of this comprehensive investigation tended to reinforce the doubts felt about mergers as generators of improved company performance.

c) Hughes et al (1986). This study focused on the relationship between financial institutions' holdings and companies' economic performance. Data was used on institutional holdings for a sample of 300 UK industrial companies over the period 1971–80. Overall the results showed a decline in profitability following merger. However, it was small in magnitude and only statistically significant in one year. The results for acquirers with large institutional holdings were different, showing some improvement in profitability, though again the results were not significant.

d) Kumar (1984). This study investigated issues relating to the growth of firms over the period 1960 to 1976, using data for 2,000 UK quoted companies. As part of this wider examination, some analysis of post-merger performance, examining the impact on investment as well as profitability was conducted. The results were rather mixed, showing some tendency towards a worsening in profitability performance and an improvement in investment post-merger. However, there was a significant minority of mergers showing a worsening of investment performance and an improvement in profit. Disaggregating the sample, Kumar's results showed that non-horizontal (i.e. vertical and conglomerate mergers) led to a clear improvement in performance while the results of horizontal mergers were more mixed with no pronounced trend.

e) Holl and Pickering (1986). The aim of this study was to discover the determinants of successful and unsuccessful takeover bids. Performance was measured using profitability and growth and the data consisted of a matched sample of 50 abandoned and 50 consummated UK mergers. Overall, the results showed that mergers appeared to have an adverse effect on profits and medium-term growth. Of particular interest is the result that both bidding and target companies in abandoned mergers performed better than the matched sample of successful bidders. The conclusion of the study was twofold:

(i) that the threat of takeover was an effective spur to efficiency and

(ii) that consummated mergers do not, on balance, lead to efficiency gains.

f) Ravenscraft and Scherer (1986). The aim of this study was to assess whether acquired companies showed superior post-merger profit performance relative to control groups and their pre-merger performance. The study covered the mid-1970s and used US data. The results showed that in just over half the sample, profits improved compared with the pre-merger period. In those cases where profits declined, the counter-factual question of whether this would have happened if the merger had not taken place was addressed. It was found that the profits of merged companies fell more rapidly than those of the control group. One interesting conclusion is that in contrast to Kumar's findings, conglomerate mergers performed less well than horizontal mergers.

g) Sturgess and Wheale (1984). This study used annual shareholders' rates of return as a measure of post-merger performance. 52 UK firms were assessed over the period 1961–70, including 26 firms that had grown through acquisition and 26 through internal growth. The results were inconclusive with neither the merger intensive group nor the internally growing group consistently out-performing the other.

h) Firth (1980). The approach used in this study was similar to that of Sturgess and Wheale, involving an assessment of gains and losses to stockholders. A sample of 224 successful UK takeover bids over the period 1972–74 was used. On average, the stock market took a slightly pessimistic view of these mergers, with gains and losses fairly evenly balanced. The author concluded that mergers were not value creating and were more likely to be motivated by maximisation of management utility reasons than by maximisation of shareholder wealth.

i) Franks and Harris (1986). This again examined shareholder wealth effects of corporate takeovers, using data on almost 2,000 acquisitions over the period 1955 to 1985. The results showed large returns to acquiree shareholders in the form of large acquiree bid premiums, which were even higher in the case of contested bids. Post-merger performance of acquirors over the two years following the merger, showed returns comparable to general stock market prices, but insufficient to keep pace with the acquiror's own pre-merger performance.

III. Conclusions

4. Evidence on post-merger performance that has emerged since the Green Paper supports the earlier findings of disappointing or inconclusive performance. Indeed, the consistency of the results of the various studies and the wide range of approaches used tends to reduce the force of the methodological limitations and to increase the robustness of the findings.

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Man", though in their evidence to the Wilson Committee the Clearing Banks were rightly able to show that their high profits were partly an illusion of historic cost accounting and that inflation adjusted accounts showed a different picture.

The banks woke up to their profit potential. Barclays, for instance, in 1972 subjected all staff to intense training in marketing, and backed it up very successfully with "management by objectives". **Bank managers found that proper marketing could make nonsense of the economists' theories about high interest rates discouraging borrowing.** People were eager to borrow and only needed the opportunity to do so, even if the APR was 31%. It is now clear that the limitations on the appetite of the public for credit are first the borrower's ability to service his loan and secondly the lender's prudential limits. The latter tended to be relaxed and few now remember the time when building societies refused to lend on houses built before 1919 or would not take into account for loan limits the earnings of a married woman.

Even at a rate of interest of 14% the willingness of the public to borrow on mortgage was sufficient in 1989 to push the value of the plot of a new house to perhaps 40% of the total price, 60% in the case of larger houses. In the 1950s 10–15% was normal. Any house price inflation which is higher than general inflation is ultimately reflected in the value of building land. I attribute the rise in house prices as much to credit creation as to demand, though one must bear in mind that because house prices have risen on average 3% faster than the Retail Prices Index since 1957 houses have become a popular hedge against inflation. Because they are a hedge against inflation their prices have risen faster than inflation. Chicken and egg! Which comes first?

The proof of the new theory

The final blow to monetary theory came in 1988 when it was clearly demonstrated how easy it is to expand the money supply once the capital base is available. Barclays Bank's £920 million rights issue in April 1988, added to other increased capital resources, enabled it to expand its balance sheet by almost £17 billion (19%) by the end of the year, to be responsible for 33% of the increase in M3, to expand its UK lending by 32%, and to increase its mortgage lending by 51%. This was done while high interest rates were supposed to be controlling inflation but were surely assisting its growth. Admittedly the rates of interest at the time of the issue were lower than for some years, but they were higher than in other countries, and minimum lending rate was, at its lowest, not much less than five times the level of Bank Rate during the 1939–45 war. After the issue interest rates rose.

Thanks to Barclays Bank the error in monetary theory was fully revealed. In the 15 years between 1948 and 1963 the deposits of the clearers rose 34.5%; in the late 1980s Barclays needed just over two years to increase its deposits by the same percentage. It is inconceivable that this could have been achieved without high interest rates.

The key to inflation control is thrown away

But the Chancellor of the Exchequer had already abandoned the pass for in March 1988 Mr. Lawson announced that he was going to throw away an unused weapon, the

Control of Borrowing Order. This should have been used to limit the capital bases of banks and of other licensed money lenders (who are said to number 240,000), every one of whom can assist the expansion of the money supply. Such an effective weapon of monetary policy however needs to be wielded dexterously.[1]

I intend no criticism of Barclays or any other lender. They were merely going about their business. Moreover moderate inflation is preferable to recession and infinitely preferable to deflation. Unfortunately all monetarist methods of controlling inflation, if effective, cause unemployment and the effect is enhanced by the Trade Unions who will not forego wage claims even when they know a determined effort is being made to limit the money supply. Some would say that because monetarist methods can only achieve their purpose by causing unemployment an incomes policy is preferable. Indeed on referring to the report I made on a conference on "The Economic Problems of Inflation" held at the Civil Service College, Sunningdale, 8th – 12th October 1973 I see that I wrote as follows:-

> "At the end of the seminar everyone present was agreed that an incomes policy was necessary. Although the monetarist view was appreciated there was no one who agreed with Enoch Powell that the problems could be resolved by purely monetarist measures. The importance of the money supply was not under-rated but it was felt that a monetarist solution must in present circumstances and given the present attitudes of trade unionists result in high unemployment. It was felt that if inflation was to be contained and unemployment kept low, then physical controls were needed. Everyone appreciated however the distorting effect of controls and no-one was still happy at the idea of long term controls. No-one seemed to have any faith in voluntary restraint."

Injustice and inhumanity prevailed

No satisfactory incomes policy could be devised and in the end the "unjust and inhumane" method had to be used. My prophecy about the trade unions was fulfilled and the unemployment situation was made worse by the slowness of the Thatcher government to introduce trade union reform which reduced the destructive power of trade union leaders.

The causes of deflation in the 1920's

Once the importance of capital base of banks is appreciated the deflation of the 1920's becomes understandable. The damage was perhaps not done by the "high" Bank Rate of 5% that so disgusted Keynes in 1925, but by the ban on new issues of capital, which was presumably applied to banks, and by the ban of foreign investment.

Foreign investment, which I define as a real transfer of goods and services abroad, increases employment. Keynes knew this but he preferred investment at home as he thought the multiplier did not take effect when investment is made abroad. This must be a mistake. The money is spent in the exporting country and must increase demand there. The multiplier must act in the country making the investment abroad and indeed may be stronger when the investment is made abroad.

1. I am not confident that the British monetary authorities would be dexterous and I therefore publish my theory with some fear that more damage might be done by ignorant use of an effective weapon than has been done with an ineffective one.

Conversely disinvestment abroad must, by definition, cause an increase in imports. In 1985 Mr. Roy Hattersley proposed to the Labour Party Conference a policy of forcing the pension funds and other investing institutions to repatriate some of their foreign investments. Before the conference I sent to seventeen trade union leaders a paper explaining why this policy was ill-founded and could further diminish Britain's manufacturing industry. One replied. A substantial disinvestment did take place at the end of 1987 and happened to coincide with the appearance of a trade deficit.

If the ban on new issues in the 1920s affected banks there was no hope of expanding the money supply even if the government had wanted it. Did the post 1931 boom fade out when the banks' capital base for creating new money had been used up, and low interest rates both prevented further expansion of the capital resources of the banks and discouraged the requisite level of saving?

After the second world war the raising of capital was for a long time controlled by the "Capital Issues Committee" (called the "Curious Issues Committee" by the late Harold Wincott). Did it reject applications from banks to raise new capital? Bank shares were not then a profitable investment and were dubbed by one Financial Times columnist "vaguely participating preference shares". The first rights issue I can recall was Barclays' in about 1961.

There is a consolation. The expansion of the money supply in recent years could have been more rapid if the banks had not lost so much capital. First there was the secondary banking crisis of 1973–74. That resulted from the extraordinarily narrow definition of a bank that was used by the Bank of England. A bank is any organisation that makes loans and accepts deposits, and any such organisation is capable of expanding the money supply. The Bank of England closely corseted the clearing banks but let the secondary banks mushroom dangerously until many collapsed. Then came the confusion over leasing, a clever contrivance that had its origin in the rules of corporation tax. The mathematics of that operation must have been beyond the comprehension of most bank directors and the whiz kids called the tune. Leasing would eventually have caused taxation problems even if Mr. Lawson had not pulled the rug from under it in 1984 for it depended on continued inflation to cause the indefinite deferral of huge tax liabilities. After that came the losses from recycling the deposits received from Latin Americans and other foreigners (possibly including Eastern Bloc citizens) back to the governments of the countries from which the money originated. More recently there has been the interest swap crisis.

Conclusions

The imposition of Corporation tax led to a rising demand for loan finance. Interset rates were bid up to levels which made it attractive to banks to aggressively market credit whilst at the same time these high interest rates enabled them to attract the necessary deposits. Controls on bank lending were progressively abandoned whilst high interest charges have increased cost inflation and led to output contraction through unemployment. The route to reduced inflation lies through a return to equity finance, to lower interest rates and to a review of recent credit control reforms.

Epilogue

In 1973 the classical form of corporation tax was replaced by the imputation tax system, a variant of corporation tax which does not discriminate quite so much in favour of debt capital. Lord Kaldor, the advisor credited with the policy of introducing the classical form of the tax, was horrified, and he expressed his horror in the traditional manner of his adopted country: he wrote to the "The Times". In his letter he prophesied that the imputation tax system would encourage companies to distribute a larger proportion of their profits and to retain less.

His reasoning was false and the statistics show that Lord Kaldor was completely wrong in his forecast.

THE RELIEF OF THIRD WORLD DEBT

By Mr Larry Trimby

The background to the present position is, briefly, that the boom of the seventies flooded the banks with cash for which they sought borrowers. The weaker the borrower, the higher the risk and the greater the rate of interest charged; as certain officials of the banks concerned held the view that countries could not become insolvent, the countries of the Third World were pressed to accept loans for development; it was a great temptation for those in charge of the exchequers to accept the means offered instead of increasing taxation, to balance their books. Governments through their parliaments can initiate proposals for the *writing-off of sovereign debt* as indeed did the British Government in 1987 when it agreed to write off £263 million of loans to sub-Sahara countries and to lengthen repayment periods.

But so far as Britain is concerned, the chief function of Government lies in its ownership through the Crown and Parliament of the public's currency, which is passed to the bank's for distribution. The function of the banks, as the Bank of England says in the *City Today* (June 11 1986) "is an unsung but vital series of money transmission and settlement systems": this together with the function of lending at interest rates, which in 1987 brought in over £9 billion.

But beggars do not seek to borrow money: they hope by playing flutes to earn some pennies thrown into their caps by compassionate travellers. For all wealth is created by the exchange of goods and services, where money is the medium of exchange. The banks should never have lent the money in the first place.

The solution lies in the swap of outstanding loans and interest for equity investment. Let the debtors earn their way out of their predicament to the ultimate great benefit of their people.

Let us take Argentina as an example, because of U.K. involvement following the Falklands War and the talks, which are about to take place with the new Argentine Government. Argentina's equity potential is considerable, measured in terms of land and mineral resources. Of a total land area of 700 million acres, farms occupy 425 million acres. The total petroleum production exceeds 30 million cubic metres, there is also coal, lead, zinc and other mineral products. 1988 saw the disbursed external debt standing at around US$bn 60 (Source: Comision Economica Para America Latine (CEPAL).

Under a Trade Treaty with the Argentine Government, an Argentine Development Corporation could be formed, whose shareholders would be the current list of creditors. To them the Argentine Government would grant a 99 year lease of land assets valued at the up-to-date value of loans and interest. A public issue of ordinary shares would be made to fund development, the Argentine Government would have the option of taking over the Corporation and terminating the lease: or such other arrangement as the parties concerned might wish to make.

Such arrangements could apply to all debtor countries. In order to stabilise Third World goods prices, the following suggestion was published in *The Times* of April 22nd 1980, from the writer, "Is not the solution to helping the Third World to pay its way found in providing a steady market for the goods produced by the poorer, developing nations, rather than by sending more aid?" Such is the idea behind the system outlined by L. St Clare Grondona in his book *Economic Stability is Attainable* (Hutchinson, Benham, 1975) which received powerful support from Sir Roy Harred, when adviser to the International Monetary Fund.

The system envisages the formation of a United Kingdom Price Stabilisation Corporation to stand ready to buy or sell commodities as offered to it or demanded of it. On no account would it intervene in the market; hence its difference in operation from that of the buffer stock.

An initial reference price is given to a commodity based on the previous five-years' average; the corporation then stands ready to buy at 10 per cent below reference price and, when it holds stocks, to sell at 10 per cent above. Thus a floor to the market is created close to the low point and, when stock is held, a ceiling close to the high point.

Each commodity is given a block volume roughly equivalent to the United Kingdom's imports of that commodity for one month. As each block is accumulated, so the buying and selling prices are automatically reduced by 5 per cent; as the number of blocks reduces so prices reverse by 5 per cent.

The corporation would only deal in sterling, hence the primary objective would be to stabilise sterling and prices to industrial users in the United Kingdom. If this objective could be attained, then we would go some way towards bringing economic stability to producers, which, in turn, would encourage overseas investment.

The benefits of this system to the developing countries have been well put by the late

Professor Lord Kaldor: "Mr. Grondona's proposal would create a powerful automatic stabiliser for adjusting the growth of demand to the growth of supply of primary products through its repercussions on the effective demand for industrial goods ... in the longer run it is the supply of basic materials, which would set the limit to the rate of growth of world industrial production and not, as now, the rate of growth of effective demand, emanating from the advanced countries, which governed the trend rate of growth of investment and production of primary commodities".

In his book, mentioned above, the late St. Clare Grondona outlined in some detail the storage requirements for his scheme, all of which would be help in the United Kingdom, giving powerful support to sterling. The scheme has already been brought to the attention of the European Community to avoid food mountains, but, it is understood to have been rejected by France, who did not like the idea of prices falling in the circumstances outlined above.

There appears to be nothing to prevent this scheme going ahead during the next Session of Parliament.

THE EDWARD HOLLOWAY COLLECTION REVIEW

These Things Shall Be
Tom Sargent
Published by Heinemann 1941

This remarkable little book combines several important themes. First it contains an outright and truly revealing condemnation of the running of the British economy, British foreign policy and British domestic policy during the interwar years. Sargent catalogues our faults and claims (p. 70) that "Hitler is a monster of our own creation". Secondly, the book contains a statement of the author's Christian understanding and beliefs – a set of ideas which can lend maturity to any pulpit. He sees life as dominated by two opposing principles – Christ power and evil; as inevitably linked together as Newton's law that for every force there is an equal and opposite force. Hitler therefore had a role to play – through his evil to call forth Christ's will in the Allies. Pacifism creates difficulties and Sargent goes to great length to explain pacifist views. But concludes "You can reason with and placate a reasonable person, but not a mad dog. This became England's difficulty with Germany".

Thirdly, the book contains a mixture of sense and nonsense in the understanding of economic problems. Clearly he has read widely. He scorns economists generally but goes on to describe Keynes and Hobson as geniuses. He clearly misunderstands the basis of money creation however when he suggests that if a man borrows £100 he cannot repay £110 (i.e. the original sum plus interest) unless new money is created. This argument ignores the difference between money *stock* and money *flows* because money moves in time and the original £100 can be spent and earned several times before the time period for interest payment is due. To such misunderstanding he adds "Men like Douglas,

Soddy, Tavistock, Peddie and Eisler all stress the fundamentally false view of money which society now holds and the problem of providing purchasing power". Pages 45 and 46 however, contain a thought provoking list of economic reforms of value for any policy institute casting around for fresh inspiration today.

Fourthly he castigates all for lacking good leadership. Conservatives are seen as little more than the fools of vested interests. On the subject of Socialists he says, "Great Britain has always ranged the world with a sword, a Bible and a cheque-book. Most Socialists are ashamed of the work done by the sword and the cheque-book, and since they are a bit embarrassed by the Bible, they do not put as much on the credit side of the British Commonwealth as it deserves."

But the over-riding aim of the book is to put forward the inspiring claim that the war had to be fought to facilitate a Christian revolution. The real enemies are selfishness, the power of money and social injustice. Hitler is merely the tool that has awakened our collective will. He says "They (the British soldiers) will not fight a second world war to make England safe for a privilege". "We must have a revolt in Britain. It must come whether we want it or not, because the people will no longer be fooled."

It is a sad thought now in 1990 that such an author who was clearly well informed and well intentioned, was also terribly naive.

JB

BOOK REVIEW

Monetary Analysis
by Thomas B. Haran
Published by The Book Guild Ltd. 1990. Price £14.95

After 43 years' experience in the world of banking Thomas Haran has had the courage and the energy to set out his own perceptions of the nature of money, its role in the economy and the consequences of public policy based on misconceptions. In principle it is not a difficult book to read and understand – almost the reverse given the pedantic thoroughness with which he traces simple and obvious relationships. But this impression of simplicity is misleading, because, at the end of the day, his concepts and terms do not 'mesh' with everything else one has read on the subject. Therein lies both challenge and weakness, value and potential obscurity, enlightenment and misunderstanding. The fact that the book contains no bibliography or any reference to other authors is a disappointment but the book can stand without that as a clear and logically uninterrupted statement of the author's line of thought.

Haran begins by defining money as debt, something created when A does something for B and destroyed when B in turn does something for A. The money supply is the amount of obligations outstanding at any one moment. Thus money is not a catalyst for economic activity but rather a facility for lots of people to create indebtedness to each other. An increase in this facility should be the consequence of increased economic activity.

The role of banks is simply to keep a tally of the process whereby debts are incurred and then repaid. Money, for him, is *only* created outside of the banking system because banks cannot make any entry in their books unless someone outside the bank is prepared to render a service of some sort and someone else is prepared to incur a debt in exchange for the value of that service. Since money thus defined is continually being created and destroyed it is nonsense to talk of 'money stock' having a 'velocity of circulation'. 'Monetarists' from Fisher to Friedman if understood to claim a deductive relationship between money creation and economic activity are shown to be mistaken – though Haran does concede that if that are merely pointing to a coincidental statistical correlation, their observations are interesting enough.

It follows that full employment prosperity occurs when conditions of stability, confidence, technical innovation and stable money values encourage everyone to participate in the maximum mutual indebtedness. A substantial increase in the *real* money supply is a *measure* of success. Inflation destroys the value of debts and thus reduces the *real* money supply and thus causes reduced economic activity and unemployment. For Haran, the only true cure for inflation lies in arriving, via the market place, at non-inflationary money rewards for the services each of us perform and he makes a novel suggestion for public policy – that by legislation employers should be obliged to match any increase in their overall wages and salaries beyond current inflation levels with an equal percentage cut in their prices. This is an intriguing idea with great advantages over the conventional 'incomes policy' concept – though it would be useful to hear more about his proposed method of enforcement. We live in difficult times and new suggestions should be given a fair hearing.

'Brainstorming' is a creative technique whereby a group of discussants deliberately suspend critical faculties in order to allow the tender blossom of creative thought a chance for full bloom. This is the attitude with which readers should initially approach this unusual book – and they will be amply rewarded.

Sooner or later though, one's own thoughts must re-engage and pose important questions. If money is to be seen as outstanding debt this must be related to consumption deferred – which must be close to the conventional notion of savings. The amount of savings people are prepared to keep as balances in banks is the true meaning of the concept of 'velocity of circulation' – which slows if people are prepared to hold more idle balances. It is true that our normal method of measuring velocity (as GNP divided by M_3) is inadequate but I doubt if Fisher and Haran are as far apart as this book rather exaggeratedly claims. And again, there are many who would feel distinctly uneasy about Haran's approach to the problem of inflation.

But the whole subject of monetary analysis is now open to redefinition and reinterpretation. Referring to Britain's latest money supply statistics, 'Lex' in the Financial Times (21/2/90) stated "The Budget gives the new Chancellor a golden chance to abandon the whole charade". Towards finding a replacement approach Mr Haran has made a valuable contribution.

J.B.

FUTURE PROGRAMME

The speakers for the next quarter programme of Economic Research Council meetings are as follows:

Tuesday April 3rd	Alan Beith M.P.
Wednesday May 2nd	Robert Malpas, Chairman of POWERGEN plc
Tuesday June 5th	Professor Marquand

NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

OBJECTS

i) To promote education in the science of economics with particular reference to monetary practice.

ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.

iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

v) To publish reports and other documents embodying the results of study and research.

vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.

vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.

BENEFITS

Members are entitled to attend, with guests, normally 6 to 8 talks and discussions a year in London, at no additional cost, with the option of dining beforehand (for which a charge is made). Members receive the journal 'Britain and Overseas' and Occasional Papers. Members may submit papers for consideration with a view to issue as Occasional Papers. The Council runs study-lectures and publishes pamphlets, for both of which a small charge is made. From time to time the Council carries out research projects.

SUBSCRIPTION RATES

Individual members	£18 per year
Corporate members	£50 per year (for which they may send up to six nominees to meetings, and receive six copies of publications).
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APPLICATION

Prospective members should send application forms, supported by the proposing member or members to the Honorary Secretary. Applications are considered at each meeting of the Executive Committee.

CHANGE OF ADDRESS

The Economic Research Council has a new address

Benchmark House
86 Newman Street
LONDON
W1P 3LD

The telephone number (071) 439 0271 is unchanged.

APPLICATION FORM

To the Honorary Secretary
Economic Research Council
Benchmark House, 86 Newman Street
LONDON W1P 3LD.

Date ....

APPLICATION FOR MEMBERSHIP

I am/We are in sympathy with the objects of the Economic Research Council and hereby apply for membership.

This application is for *(delete those non-applicable)*	Individual membership (£18 per year)
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	Associate membership (£10 per year)
	Student membership (£8 per year)
	Educational Institutions (£35 per year)

NAME ....

(If Corporate membership, give name of individual to whom correspondence should be addressed)

NAME OF ORGANISATION ....

(if corporate)

ADDRESS ....

....

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PROFESSION OR BUSINESS ....

REMITTANCE HEREWITH ....

SIGNATURE OF APPLICANT ....

NAME OF PROPOSER *(in block letters)* ....

AND SIGNATURE OF PROPOSER ....