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TWO (PHILOSOPHICALLY INCOMPATIBLE?) VIEWS OF THE WAY FORWARD

It is always useful to distinguish the '19th Century Liberal' from the 'Corporatist' philosophies of economic management. The former is about the virtues of improving market mechanisms, of competition, privatisation and minimal government roles; whilst the latter is about the virtues of the state nurturing business development both public and private, about economic security and planning and EEC developments. The terms need not be regarded as derogatory (though they are very inadequate) – they represent, perhaps, the contrasting spirits of 'father' and 'mother' in setting the business environment.

For current circumstances Lord Vinson and Lord Ezra surely gave a most valuable and succinct illustration of these viewpoints – in the House of Lords on the 7th November 1991.

POLICIES FOR RECOVERY

By Lord Vinson

My Lords, it was the Grand Old Duke of York who marched his troops to the top of the hill and marched them down again. The performance of our economy over the past 20 years closely resembles his conduct. Recession follows boom and the correctives necessary to reduce recurring inflation leave the economy with productive capacity inadequate to meet the country's requirements.

A number of noble Lords have drawn attention to our membership of the ERM and the stabilising effect that it is hoped it will have on our inflation rate; but I believe that that view is sanguine. Fixed exchange rates will deal with the symptoms by keeping us in a prolonged state of recession, but we should examine anew the causes of inflation which, uniquely to this country, are rather more fundamental. As the noble Lord, Lord Jenkins, said, the problems are deep seated. Like the hedgehog, inflation is hibernating and will reappear as the economy warms up.

Rather than rely upon the ERM mechanism alone, there are parallel actions which the Government, or indeed any government, should be taking. They should take steps to prevent inflationary pressures coming from the housing market and encourage alternative forms of saving, as the noble Lord, Lord Stoddart, said; take another look at the traditional controls of bank lending; and last but not least take steps to meet our endemic balance of payments problem.

In sum, we need a recovery strategy to ensure that growth does not rekindle inflation. I seek your Lordships' tolerance to expand upon three points which might help "to improve the working of the economy". I believe that what makes inflation in the UK almost inevitable is over-restrictive town and country planning, with the effect that that has on land prices and consequently ever-rising house prices. With that comes equity withdrawal, the feel-good factor, excessive spending and off we go to another boom: we spend too much and save too little. We are spending what we have not earned or even possess, as the illusory house market of 1988–89 with its tragic consequences have proved.

All that is fuelled by excessive bank lending because they are inadequately constrained by regulation to their monetary base. Since this subject was broached in a similar debate in your Lordships' Chamber some two years ago, the remedies are being more widely accepted – encouraging local authorities to release more land to meet housing demand where it occurs and constraining the reserve ratios of the banks and other financial institutions.

That leads me to my second point. I recognise that adequacy ratios are being tightened; but market man as I am, I believe that the Bank of England should exert its traditional role with greater determination. It should downgrade the banks' capital ratios if they securitise mortgages. It should downgrade them again if they lend money to customers at more than 90 per cent of the value of the property, or at more than 3 1/2 times the borrower's annual income. Building societies should be treated to the same effect. Houses should be subject to indexed capital gains tax just like any other investment. Last but not least, mortgage relief should be withdrawn.

In this way sensible long-term checks would be put on the amount of money sloshing about in this area. That would bring positive benefit to the first-time buyer due to the stabilisation in house prices and it would prevent the growth in credit collateral that has repeatedly fuelled our inflationary cycles. I hope that the Government will reconsider this problem. Due to the recession, house building starts are close to an all-time low, yet, out there, there is massive need in the housing market which must somehow be met without inducing a further boom.

We are left with a third major problem facing the economy, which is the supply side. The Government have done wonders to free up the labour market and reduce restrictive practices, and no doubt industry is much leaner and fitter than it was. But in capacity terms it is quite inadequate to meet the needs of the country at post-recession levels. Inevitably we shall enter a new balance of payments crisis as imports are sucked in to meet demand. That will mean that interest rates will have to rise to defend the pound and the whole grisly, self-inflicted stop-go cycle will start all over again. However, there is hope. I believe a number of helpful steps could be taken in this area and I hope that the Government will consider them.

Any examination of our balance of trade shows that it is not our inability to export that lies at the root of the problem – we export a higher percentage of our gross national product than do either Japan or Germany – but rather our propensity to import, and to import goods from others who have no inherent natural trading advantage. We import goods that could perfectly well be made within our own economy. A leader in the Daily Telegraph of Saturday 15th June stated:

"The recession has once again emphasised the fundamental weakness of the British economy that we do not produce sufficient goods of the kind we ourselves wish to buy. The folly of the view taken by some influential economists in earlier years that manufacturing is unimportant is now recognised". What a baleful and damaging

influence that was within the Treasury.

The argument that manufacturing no longer matters at all and that the UK can make its way largely through service industries always was bogus. I see not a grain of evidence to support this concept in any other major trading nation. The world's most successful economies, both traditional and emerging, are those that give priority in the formulation of their economic policy to the manufacture of materials goods for a material world. They do so not only because they are more exportable but because productivity gains from manufacturing are easier to obtain and, thus, high real wages can be paid without high inflation. Productivity is not everything but, in the long run, it is almost everything. A nation's ability to improve its standard of living depends almost entirely on its ability to raise output per worker.

Why bother to have science, engineering or chemistry at our universities if there is no outlet for these fundamental talents? As the world gets more scientific we should be aiming to make our trading base more so not less. However desirable tourism and the service sector are, most services are simply not exportable and cannot substitute for imports. We must expand our productive base as we need it more than ever. Present levels of investment, although better, are quite inadequate to meet a demand upturn.

Our manufacturing underperformance is a symptom of a more general economic malaise, because when a country is forced to use high interest rates as the mechanism for containing inflation or holding the exchange rate, it shoots itself in the foot because manufacturing industries – slow cycle, higher capital cost industries – are precisely those that are doubly hurt by high borrowing costs. As the service industries in turn become more capital intensive, this will apply to them too.

Perhaps it would be helpful to spell out the cost to business of inflation which, over the past four years, has totalled some 30 per cent. This means that the working capital requirements of every business in the country have gone up by 30 per cent. The clear proof of the effect of this is the record bankruptcies we see around us today, where companies starved of cash and sales simply run out of money. The flood of rights issues currently being handled by the Stock Exchange is a sign of larger companies trying to replenish their liquidity. But for smaller companies, reliant as they are on bank lending, there is no alternative but to retract or go bust. It is this retraction that has been so damaging to our productive base.

The matter has been compounded by the accountancy profession, which has sat on its hands over the introduction of inflation accounting. That profession continues to produce accounts which grossly overstate real profitability, by failing to index stock or make allowances for replacement of plant at present rather than historic levels. The consequence of this is that many companies are paying tax on wholly fictitious profits when they should not be paying tax at all. That is yet another blow to corporate liquidity. If the accountancy profession and the Inland Revenue had together conspired to think of a system more likely to damage capital investment and accelerate bankruptcies, they could not have bettered it. Hundreds of thousands of people who were encouraged – I helped encourage them – to start their own business over the past 10 years have been betrayed by a financial system that handicaps rather than supports them.

It really is ironic that full relief is given to all gains on house purchase and full indexation to the ownership of stocks and shares, but relief is no longer given to the wealth creating heart of the economy. While the general "across the board" cut in corporation tax was good for many businesses such as finance houses, property developers and cash businesses like retailing, the withdrawal of indexed relief was singularly bad for the high capital intensive business. Many of us believe that that is just the sort of business this country needs.

At this point when inflation is being contained – I give full credit to the Government for that – it is perhaps too late to introduce inflation adjusted accounts and indexed stock relief, but it would be timely to do something about the cost of money. That is a matter that affects every investment decision. A relatively simply solution is at hand. Your Lordships will recall a debate in this House earlier in the year on the report of the Science and Technology Committee. It clearly showed that there was no shortage of innovative ideas in the UK but rather a shortage of capital at the right price. This is a key issue. Over 20 years the cost of capital in the UK has been higher, and often much higher, than that of our competitors as a consequence of our anti-inflationary fiscal policy.

Currently interest rates are absurdly high. Unless real interest rates fall, there are limits to the amount of productive investment that pays at current levels. Investment is not and simply will not take place at an adequate rate and our supply side problems will remain. It is a sad irony that one of the consequences of being in the ERM is that our interest rates are likely to remain high when they should be falling due to German borrowing to re-equip Eastern Germany. They will repair their manufacturing base at our expense.

Somehow we must offset this handicap. Let us try to be positive about this. What steps can we take within EC competition policy, within our own control and without subsidy to strengthen our manufacturing base, to replenish its liquidity, to reduce the cost of capital and to mitigate the ravages of inflation on corporate liquidity?

The concept of two-tier interest rates is unworkable, but what we could do is to allow our businesses to use their own self-generated funds for investment before they pay tax. The Japanese do this and indeed, it is one of the secrets of their success. Let us take a leaf from their book. So, I would suggest to the Government that they re-implement the following policy: allow capital equipment to be charged as a revenue expense for taxation purposes in the year in which it is purchased. This is not a tax handout; it merely shifts the cash-flow benefit of depreciation back from the Treasury to the business concerned, and after some five years is virtually tax neutral. Accelerated amortisation was one of the most helpful aspects of our corporate tax structure prior to the Lawson reforms where he threw out the baby with the bath water. It should be re-introduced as a matter of urgency. As a fundamental matter of government policy anything which raises industrial and manufacturing costs and thus inhibits exports or encourages imports should be reviewed.

Reducing costs to our productive industries by tax mitigation would help counterbalance the inherent disadvantage of attempting to invest and grow in a high capital cost economy. One very much appreciates that the Government's sensible priority is to keep corporation tax low, but the re-equipment of industry lies at the heart of our economic

success and should be a first call – even if other less capital-intensive businesses have to pay a touch more corporation tax pro tem.

Those and other changes must be debated more widely and not dismissed as special pleading from business. The Department of Trade and Industry, where we have had 12 Secretaries of State in 12 years, will, one hopes, under its excellent present incumbent, reassert its role as an influential department of state whose views really count.

In conclusion, I hope that the Government as part of their recovery strategy take essential steps to tackle the underlying causes of house inflation and, more importantly, increase the nation's productive capacity by letting companies use their own self-generated funds for investment before paying tax. I fear that without such action the Grand Old Duke of York, in the form of an economic cycle, will be seen to have marched us up to the top of the hill and marched us down again.

POLICIES FOR RECOVERY

By Lord Ezra

My Lords, with a general election looming it is only to be expected that attention should increasingly be focused on the economy; hence the importance of our debate today.

Of course, because we happen to be going through a recession, attention is directed mainly at the prospects for recovery. A variety of signs are identified by the media every day of the week which appear to suggest either that we are on the way to recovery or that we are not yet on the way to recovery. On balance I believe that probably a slow recovery has set in. It will take a long time and for some time it will be accompanied by an unacceptably high level of unemployment. However, like other noble Lords who have spoken, I should like to concentrate on some of the longer term aspects.

It strikes me as very important that in seeking to emerge from the present recession we do not sow the seeds of the next one. The noble Lord, Lord Brabazon, spoke not only about signs of the recovery having set in; he considered that we were now entering a period of sustainable, non-inflationary growth. I am afraid that I cannot agree that there are yet signs that that is likely to occur.

What worries me particularly is that in looking for prospects of recovery from the present recession we seem to be hoping for a resumption of consumer spending. Yet it was precisely an excess of consumer spending which pushed us into the recession. The question can fairly be asked: how would the government of the day, from whichever side, deal with the level of consumer spending in the future when it reached a point of overheating?

I recall the many debates on the economy which we have had since 1988 in which a number of us from these Benches have drawn attention to the overheating of the economy. The Government's response was that it was not overheating; it was real growth. As it turned out it was not healthy growth but a form of economic obesity. We must ask how we are to avoid suffering from similar excessive indulgence in the future.

I have recently returned from a meeting in France. I often go to the Continent, as do many of your Lordships. I met a number of industrial and financial personalities. France has an economy very similar to our own. It is much the same size. France has run into similar difficulties and has a high level of unemployment. The French have also coped increasingly well with inflation. The present rate of inflation in France, at 3 per cent, is lower than ours. But the French are worried about the future and how they can recover.

In their recent budget the French Government set out a policy for recovery. It is different from ours because it puts the emphasis on a resumption of investment and a massive stimulation of exports. The budget estimates show consumption running level, one year with another. They also show a high level of savings, of not less than 12 per cent., being maintained this year and next.

I believe that that is something we should seriously consider. Should we not be looking at a way out of recession which really sows the seeds of long-term sustainable growth? I do not believe that a re-stimulation of consumer spending is the right way forward. I do believe that what is required is a stimulus of investment – and I hope that the Budget will include measures to achieve that – and a massive resumption of effort in the export market to improve even on the better results which we have recently achieved.

That is very much the view which has come out of the recent report prepared by the CBI's manufacturing advisory group. The report states quite positively, in respect of government relations with industry, that the policy to benign neglect is no longer sufficient. It calls for a new partnership between government and industry. It draws a distinction between support on the one hand, which would be welcomed, and intervention on the other, which the CBI does not ask for.

In particular the CBI report draws attention to the position of the DTI, which has figured in some of our previous debates on the economy. It emphasises that the dual roles of the DTI, on the one hand as a regulatory body and on the other as a body which is intended to stimulate enterprise, can no longer co-exist. The report calls for a separation of those roles so that the government department concerned with industry will wholeheartedly support industrial policies and fight its corner in Cabinet and elsewhere for that purpose and not be confused by its regulatory role, which must consistently be holding it back. I hope that that proposal will be considered very seriously by the Government.

The time has indeed arrived, appropriately with an election coming up, for a reconsideration of industrial strategy, for a restructuring of government responsibilities, for much greater stimulus of investment and more positive export promotion. I deplore the Government's privatisation of the insurance services group of the ECGD. That will not help our export effort; it will simply add a degree of confusion. More attention should be paid to the transport infrastructure and to training and research, as we heard yesterday the Government intend to do. However, it worries me that that effort is being made so late in the day. It is something we have been seeking for years and could easily have been financed at an earlier stage when we were receiving the benefits from the North Sea and when privatisation revenues were at their height. It is now being done – we welcome it being done at all – when it is likely to lead us into a severe PSBR situation, a borrowing requirement of no less than £10 billion this year and, as it is generally

estimated, of not less than £20 billion the following year. Although we welcome the steps now being taken, can they be sustained alongside such a high PSBR? That matter must be considered.

We must have a positive policy towards the European Community. We have the opportunity to play an effective role there – the Prime Minister himself has said so – but, as my noble friend Lord Jenkins of Hillhead said, we appear to be making the worst of our position, probably ultimately signing the agreement on economic and monetary union but deploring it frequently before we get to the table for signing. That does not put us in the best negotiating position.

Above all, in the period ahead, we must avoid diverging from our main task of bringing about sustained industrial recovery. I fear that one of those diversions is the proposed privatisation of the coal industry to which the gracious Speech referred. The Government say that they are continuing to prepare for that privatisation measure. The problem facing the coal industry is what kind of future it will have and how effectively we can reconcile its various difficulties and maintain a viable source of indigenous energy for a long time in this country with all the skills we have for exploiting it. That is the main issue, not the question of ownership.

However, if the Government are in a position to carry that through, I should draw their attention to two features which, above all else, must not be broken up in any privatisation venture. Those features relate on the one hand to safety and on the other to research.

First, the mining operation is inherently unsafe. British mining experience has shown that we have made it the safest underground mining venture in the world. I played quite a part in that during my period in the industry. That tradition and experience of safety cannot be maintained if the responsibility is broken up.

Secondly, research in the mining industry is concentrated in two research centres. The first is mining research. There again, Britain leads the way in long wall mining technology. Substantial exports of such equipment have been based on our research effort. The second is a research centre on coal and the use of coal which undertakes a great deal of work on clean-coal technology, now becoming much more important given the environmental pressures.

I impress upon the Government, with regard to any plans they have for privatisation, not to break up those research centres. The question of research arose when we debated the Electricity Bill. It was never made clear what would happen to it. Long term research in electricity generation has in fact been severely curtailed by the existing generating companies whose pressures and objectives are different from those that existed at the time of the Electricity Council which co-ordinated the research. We should be warned by what happened in the electricity industry and prevent it happening in another basic industry.

I should like to conclude still on the subject of energy, but on a more positive note. I welcome the increase mentioned in the Autumn Statement in the funding of the Energy Efficiency Office. We have debated funding in that regard many times. We believed that it was inadequate, but the Government have announced that it is to go up from

£42 million to £59 million. A large part of the increase is to be spent on the home energy efficiency scheme which is handled largely by Neighbourhood Energy Action of which I have the honour to be president. That organisation insulates the homes of people on low incomes, particularly the elderly. We are doing so at present at the rate of 200,000 a year. The increased revenue will enable us to achieve a level of about a quarter of a million a year and I am grateful for that.

I thought, in concluding, that I would balance what I had to say with a positive expression of appreciation to the Government. I hope that it will tempt them to take on board some of the other remarks that I have made.

JAPAN: THE HARA-KIRI ECONOMY

By Brian Reading

I would like to start with a cautionary tale.

A young ship's officer, on shore the night before he sailed, imbibed a little too freely. During his first watch the next day, he observed an entry in the ship's log. It read,

"Last night the second officer was drunk"

Later, he asked his Captain whether it was really necessary to record this in the ship's log. The Captain replied that the log had to be a full and truthful account of all that went on on his ship. The following day the Captain himself read the log for the second officer's watch. It read,

" Today the Captain was sober."

When considering Japan, one must always beware that appearances and reality are seldom the same. Japan appears to be a mighty and powerful economy, poised to take over the world. It appears to have stable and far-sighted government, supported by a majority of the voters.

It is true that it is going through a rough patch at the moment. But who isn't? The bubble economy has been deliberately burst by Governor Mieno at the Bank of Japan. His high interest rates and exceptionally tight money policies sent the Tokyo stockmarket crashing last year and now land and property are falling for the first time in the adult lives of over half the Japanese people. But this is a necessary, indeed healthy, correction of the speculative excesses of the late 1980s. Naturally, falling asset prices have been followed by financial scandals. Money taken from banks in a bull market, can be profitably employed and speedily replaced. Maybe management is none the wiser. More likely it is much the richer. But when markets collapse, stolen money is lost and cannot be returned. The truth will out.

Speech given on 1st October to the Bank Credit Analyst conference in New York.

The political situation is a little disturbed, but no more than usual and a good deal less than in 1988–89, when scandals cost two Prime Ministers their jobs. The threat to the ruling Liberal Democratic party's monopoly of power from the Socialists has faded. Factions are again fighting one another over the leadership issue, but this happens every two years. What venal politicians and the Diet get up to, makes little difference to the competent management of the Japanese economy, which remains firmly in the hands of honest and efficient bureaucrats, far sighted company managers and docile, hard working employees.

High interest rates and tight money have halted the flow of Japanese capital abroad. Indeed some Japanese money has had to be brought back home. But forecasters expect the overheated real economy to cool down. They predict a soft landing, followed by moderate and sustainable growth. Mieno will ease his squeeze as inflation abates. Interest rates will fall. Indeed they have already started to come down. The stockmarket will recover on the prospect of resumed profit growth. Foreign investors may well lead the way back into it. Japanese capital outflows, particularly direct investment abroad, will gradually recover. But meanwhile the yen, supported by an increased current account surplus, will move moderately higher.

On this view, the speculative excess of the late 1980s will never be repeated. The authorities will never again allow credit to become limitless and costless to corporate treasurers. Zaitech operations, financial engineering, are a thing of the past.

Like the ship's officer, Japan got drunk last decade. It's got a bit of a hangover now, but like the ship's Captain, it will remain sober during the rest of this decade.

From the title of my talk, "Japan: The Hara-Kiri Economy", you may possibly suspect that I do not share these comforting views. It would take several hours for me to explain fully why. All I can do today is briefly to summarise my thesis, then devote the remainder of my talk to explaining how I think the Japanese situation will evolve. My guess is that Japan is addicted to excess credit growth. It will either go on another binge or, if forced to dry out, will face an extremely painful period in which it adjusts to an entirely new way of life.

In a nutshell, I believe that Japan's economic success is fatally flawed, and in ways that its present political system cannot correct. Japan is half-way house between a totalitarian communist command economy and a free market capitalist democracy. Indeed, it is more communist with beauty spots, than capitalist with warts.

It is corporatist, not capitalist. Big business is run by self-perpetuating unsackable boards, in the interests stakeholders – management, employees, suppliers and customers – have priority of those of its shareholders. It is a managed economy, in which competition is widely suppressed and collusion common-place. All aspects of industry and commerce are minutely regulated according to unwritten rules, invented by bureaucrats and enforced under the blanket authority delegated to them by vague and ambiguous laws. Moreover, the regulations imposed are invariably designed to protect and promote the special interests of whatever branch of finance, industry or commerce is being regulated, at the expense of the general interests of the society at large. Competition is savage, only where it is allowed. That is between established Japanese enterprises within narrowly defined industrial or financial sector boundaries.

Politically, Japan is a one party state, corrupt, paternalistic and nepotistic. It is a neo-feudal society, operated for the benefit of powerful and wealthy political and industrial dynasties. Fear and greed dictate how unequal votes are cast in unsecret ballots to select self-serving politicians without policies. All are not equal under the law in Japan. The barons of big industry, finance and politics consider themselves above it.

Communism produced one area of excellence, its military machine, which for a long time blinded many in the west to its other shortcomings. It collapsed, suddenly and dramatically, because it failed to deliver to its citizens the material standard of life to which they aspired and which people in America and western Europe so conspicuously enjoyed.

I must tell another little story here. A Russian delegation to Britain was shown round a supermarket. They were amazed by what ordinary people could easily buy. But they were also puzzled by the pet food shelves. They asked, "Why in such a rich country do you eat cats and dogs?" They could not conceive of food was plentiful that people bought it for their pets.

Neo-feudal corporatism in Japan has produced one area of excellence, its industrial machine. This has equally blinded people in the west to the country's shortcomings. Ordinary Japanese enjoy material affluence. They have amongst the highest living standards in the world. But the quality of life in Japan is abysmal. This is a well known point and I won't belabour it here. Sufficient to say that the average young Japanese is dissatisfied with a system which produces and supplies an excess of everything which he already has(he has nowhere to put any more), while denying him what he really wants: better and bigger homes, main drainage, more parks, better roads and rail services and more leisure facilities. He can get what he does not want and wants what he cannot get. He also recognises that the corrupt system of money politics will never change this.

The Japanese neo-feudal corporatist system is collapsing, in the manner although not on the scale or with the speed that communism collapsed. Japan has entered a dark decade. At home it faces a period of desperately slow growth, if not a depression, the disintegration of the ruling Liberal Democratic party, political confrontation instead of consensus, social unrest in place of harmony. Abroad, it faces trade war and political isolation. No American politician need be nice to the Japanese any more, now the red threat is dead. Indeed the CIA has lost no time in resurrecting the yellow peril in its place. A report it recently commissioned, "Japan 2000", feared that, "Given the situation in the US today, our economy will certainly be overwhelmed by theirs". It continued "This will spell disaster for the American standard of living for our children – indeed for ourselves if the pace of Japanese ascendancy continues unabated". Moreover it warned of a sinister plot. "Their economic power is based on a shared national vision for world domination."

Absolute rubbish, but dangerous rubbish which many Americans will willingly believe. Which is why there will be a trade war with Japan.

But enough of these generalisations. I now turn to the specific economic problems which will dominate developments in Japan over the coming decade. The first is

familiar to all. The Japanese save too much. For the past forty years, the Japanese have saved twice as much out of their national income as the Americans. High savings can be benign, bothersome or malign, depending upon how they are used. If matched by equally high investment, as they were from the 1950s to the early 1970s, they result in miracle fast growth. But fast growth is only possible for a nation with surplus under-utilised labour or fast labour force growth and an out-dated inadequate capital stock. Miracle growth always comes from catching up, it never comes from racing ahead. A modern economy, with a fully employed and slow growing labour supply can only expand at the rate dictated by technological advance, which seldom exceeds 2% to 3% a year.

An advanced economy needs to spend between a fifth and a quarter of its annual income on capital investment, depending upon how fast its labour force is growing. Most of this spending is to replace capital that wears out. With a capital stock equal to two years' GNP, wearing out at the rate of 10% a year, 20% of each year's income needs to be devoted to investment. Anything more goes to supplying additional workers with capital equipment and increasing the supply of capital relative to labour. While catching up with the West in the 1950s and 1960s Japan spent between 35% and 40% of its income on investment and financed all of this out of its own high domestic savings.

By the early 1970s Japan had caught up. Its labour force growth had slackened. Its miracle growth years were over. They were ended dramatically, with the first oil explosion. Investment inevitably collapsed. But Japan's savings remained persistently high. Consequently a structural balance of payments surplus emerged, which was bound to antagonise its trading partners. Twice during the following decade, the Japanese were rescued from the consequences of excess saving by Arab oil sheiks. The two oil price explosions turned the terms of trade against Japan. A greater volume of exports was required to pay for an unchanged volume of imports, helping to sustain Japanese growth without producing an unacceptably large current account surplus. Excess private savings were also mopped up for a time by the emergence of a large budget deficit financed out of borrowing. But the debts these produced meant that budget deficits could not be sustained indefinitely.

Following the second oil shock, America came to Japan's rescue. President Reagan's supply side reforms led to the twin US deficits. America and Japan became like two drunks, leaning against one another in order to stand up. The Japanese saved and lent. The Americans borrowed and spent. The Japanese lent their surplus savings to the Americans, who used them to buy Japan's surplus products. The result was a period of stable disequilibrium which lasted through to the mid-1980s.

The mechanics of this stability are worth considering. They provide the first example of the changed operation of the international financial system under conditions of both free trade and the free capital movements. President Reagan's reforms lowered the after-tax cost of capital in the US and increased the demand for it. This attracted an inflow of foreign funds which drove up the dollar. The strong dollar priced US manufactures out of world markets and made imports cheap. This caused a large and persistent balance of payments deficit. The increased US spending abroad enhanced other country's tax revenues. They used these painlessly to reduce their own budget deficits. So little of the increased spending leaked back into the US. This tax leakage contributed significantly to the Federal budget deficit.

This experience illustrated a fundamental shift in the relationship between payments balances and currency movements. In the days of restrictions over capital movements, exchange markets were dominated by transactions originating from trade flows. Consequently, big payments deficits resulted in weak currencies. As transactions related to capital flows increasingly dominated foreign exchange markets in the 1980s, strong currencies produced big trade deficits instead. It is no longer true that developments in real economies dictate the behaviour of financial markets. It is now a two-way street in which financial developments have a major impact on the behaviour of real economies. It is no accident that the 1980s was a decade in which economic growth rates, inflation rates and payments imbalances were remarkably stable from one year to the next, while currencies and financial markets became remarkably volatile.

The collapse of the dollar from 1985 onwards, when private investors lost confidence in the US, brought on the malign phase in Japanese excess savings. The strong yen, called "Endaka", threatened Japan with recession. The response, particularly after the October 1987 stockmarket crash, was a period of excessively cheap and plentiful credit in Japan, which led to the "bubble economy". I shall shortly examine the consequences of the bubble economy . But as this tale leads directly to my conclusions, it is better to interrupt the narrative at this point to consider why the Japanese save so much.

There are many rival explanations of high Japanese savings. All probably contain an element of truth and none provide the sole answer. Japan is the first Asian nation to achieve advanced economic status. Its people are culturally different from Europeans and Americans. They value future security more highly than present satisfaction. Frequent natural and man-made disasters encourage a high level of precautionary savings. Taxes and public spending are lower in Japan than in most other countries. The citizen must do for himself, what in European countries the state does for him. (But the same is true in America, where savings are low.) Demographics may explain high Japanese savings. The young borrow and spend. The middle-aged save and lend. The old live off past savings. There are a lot of middle-aged Japanese.

This argument has been used to show that Japanese savings will soon fall. The Japanese population is ageing faster than almost any other. More old people will mean lower savings. Unfortunately, this argument does not stand up to examination. Differences in the savings rates of Japanese of different ages are surprisingly small. Young Japanese save 20% of their income, middle-aged save about 25% and over-60s save 18%. If between now and 2010 no Japanese are born and none die, the unattainable maximum rate at which a population can age, over half would then be aged over 60. With an unchanged lifetime savings pattern, the average savings rate would drop by 1%. Savings behaviour will probably change, although increased life expectancy means more years in retirement, which might make old people disinclined to save less. But even if savings rates fall with an ageing population, so do the capital requirements of an older society with a stagnant labour force. The OECD studied this issue and concluded that the effect of ageing on excess savings could go either way.

For my part, I believe that excess Japanese savings is a result of the structure of its

economy, its tax system, the nature and level of public spending, its land use and agricultural system. I cannot describe these at length here. The problem is, however, one I have alluded to already. The average Japanese can buy what he does not want and wants what he cannot buy. Let me put this to you in the way one young Japanese did to me. He said,

> " I have three new suits. They are very good and very expensive suits. I'd like to have more. But there is not room in my wardrobe for another suit. There is not room in my house for a bigger wardrobe. I can't buy another suit, unless I buy a bigger house. But to afford a bigger house I must save very hard. That means I probably should make do with only two suits instead of three."

He also told me that it was common in Japan to hire rather than buy a new baby's cot or crib. This was because there was nowhere to store one for the next child to use. In fact there is often no room for another child, which is one reason the birth rate has collapsed. Gloomy old Malthus believed that food supplies set a limit to population growth. In Japan living space does the same.

Unfortunately, saving to buy a bigger home is self-defeating. Collectively, people can only buy bigger homes if more are built. This requires additional building land, which for a variety of reasons is not forthcoming. Without it, the more people save, the higher the price of land and the more they need to save.

This nicely returns us to the story of the bubble economy. The initial effect of cheap and easy money from 1985 onwards was to drive up asset prices. The stockmarket boomed and land prices soared. The one-third of Japanese who owned everything became effortlessly wealthy. They therefore saw little need to save so much from what they earned. Many of the two-thirds of Japanese who owned next-to-nothing gave up the hope of ever owning their own homes. They also stopped saving and spent. The result was a marked falling in personal savings and a consumer boom.

The excess savings gap was simultaneously closed from the investment side. Money became almost costless to the large corporation. With P/E ratios rising to 60 or more, and dividend pay-out ratios mostly around 25% of earnings, the cost of capital from new issues fell to less than a half of one percent. Moreover, money was plentiful, particularly through the issue of convertible and warrant bonds on international markets. In the three years to 1990, gross investment rose by around 12% a year to a third of Japanese GNP. At this growth rate it contributed 4% points to GNP growth.

The bubble economy sucked in imports, while potential exports were diverted to meeting home demand. Japan's bloated trade surplus shrank and its structural payments problem seemed to have been solved. But it was only suppressed by the palliative of cheap and easy credit, which had to be administered in ever increasing doses to remain effective.

The flaw in this solution to Japan's excess savings is simply exposed. At the height of the boom, the total value of all real estate and stockmarket shares in Japan reached ¥5 quadrillion. A quadrillion is a billion trillion. At the same time Japan's GNP was running at an annual rate of ¥400 trillion. Assuming a modest 4% return, the yield on

¥5 quadrillion of assets would be ¥200 billion, or half GNP. No modern economy could possibly function in which half of all income were rentier income. Of course it wasn't. Property income amounted to one-eighth of total incomes, the average yield on shares and real estate was below 1%. Consequently, anyone in their right mind should have sold all their assets and placed the proceeds in Government bonds, then yielding 7% to 8% a year. By the time the bubble burst, the relationship between asset prices and incomes had become obscene. Indeed that is why it finally burst.

This can be illustrated with a more down-to-earth example. The price of the average three-bedroom house in Tokyo peaked at ¥70m in 1990, when the average salary-man's income was ¥7m. Thus an 80% mortgage at 5% would have cost ¥2.8m or 40% of income. But the same house could be rented for ¥1.8m, or 25% of income. Moreover, under Japanese law, tenants have security of tenure and rents cannot rise by more than 10% in any two year period. Only an idiot would buy rather than rent.

The Japanese are not idiots. The only reason asset prices could rise so high, relative to incomes, was the conviction that they could only go higher. The ordinary Japanese came to believe that it was impossible to become wealthy out of earning, but easy out of owning. Moreover, this conviction seemed well founded. Financial deregulation had created a miracle money-making machine. Companies borrowed against the collateral of the shares and land they already owned. They speculated by buying more land and shares. This drove up asset prices producing capital gains, which were recorded as company profits. Consequently the E, earnings, in Japanese P/E ratios, became increasingly driven by the P, the price of shares. Higher stock and land prices pushed up earnings, higher earnings pushed up prices. This was basis of Zaitech, financial engineering.

At the same time, the operation of the BIS rules for banks' reserve asset ratios, which included 45% of unrealised capital gains on banks' equity portfolios, produced a wonderful credit multiplier. The more the banks lent to finance speculation, the more share and property prices rose, boosting their reserves and enabling them to lend even more. They were desperate to do so. Interest rate deregulation and financial liberalisation eroded profit margins. Their best corporate customers discovered they could borrow themselves in financial markets, particularly the Euromarkets, cutting out bank intermediation. To maintain profits, banks went for growth, and lacking enough big corporate borrowers they lent increasingly to smaller and less credit-worthy borrowers to finance speculative rather than real investment.

They also followed their big corporate clients into international markets where the regulatory climate was more benign. To some extent the explosive growth in Japanese international banking and broking operations was merely the transfer off shore of formerly domestic transactions involving Japanese as both lenders and borrowers. That is to say, they gate-crashed the international financial parties in London and New York, but took their own booze with them.

The final element in the bubble-growth saga was the flood of Japanese money abroad. During the period of endaka, from 1985 to 1988, the yen doubled in value against the dollar. From a low of ¥250 it rose to a peak of ¥120. Nonetheless Japan's

current account surplus remained in excess of $130bn, partly it is true due to the collapse in oil prices. Had long term capital outflows from Japan not grown exponentially during these years, the yen would have climbed even higher. Instead Japanese purchases of cheap American assets helped to prevent American purchases of Japanese products from forcing the yen higher until payments equilibrium was re-established.

To sum up the bubble growth years we can say that asset price inflation eliminated excess Japanese savings by fuelling both a consumer and investment boom, while the export of cheap and plentiful capital enabled the consequent reduction in the Japanese payments surplus to occur through a relative change in growth rates in Japan and elsewhere, rather than through a change in relative prices, ie, a very much stronger yen. Economically this solution was flawed because it required not high, but persistently rising asset prices. Politically it was flawed because it made the one-third of Japanese who owned or controlled everything effortlessly wealthy while leaving the two-thirds, whose only income is from what they earn, further than ever away from achieving the quality of life they desired.

The 1980s turned Japan into an extremely unequal society. Wealth and power, as in the prewar days, was increasingly concentrated in the hands of a few family dynasties, the barons of industry, finance and politics. There is not much difference between the self-perpetuating Communist privilegencia which ran the Soviet Union and eastern Europe to their own benefit, and the self-perpetuating Japanese establishment of venal politicians and their powerful paymasters who, operating in collusion with bureaucrats, enriched themselves at the expense of the ordinary citizen. The political upheavals and scandals of the past few years are not unrelated happenstances. They are the result of a grass-roots rebellion in Japanese public opinion against their entire system.

Governor Mieno of the Bank of Japan personifies this rebellion. He may, or may not, have a hidden agenda. But his actions in deliberately deflating the bubble economy were as much dictated by a desire for moral justice as for economic prudence. The 40% fall in Tokyo share prices and the rather artificial 10% or so fall in property price, have gone only part way to restoring a realistic relationship between asset prices and incomes. As such they have done something to redress the inequality of wealth, while the scandals thereby revealed are bringing to book at least some of those who previously exploited the system in the interests of personal power and wealth.

But if Japan's political problems are thereby being partially addressed, its underlying economic problems have been exacerbated. Savings are again excessive. Consumer spending has slowed down, particularly on imported luxuries. Investment prospects are deteriorating. The current account surplus widened to an annual rate of $70 billion in the first half of this year despite gulf support payments of over $10 billion. By the end of the year Japan's surplus is likely to be running above $100 billion at an annual rate. Far from a soft landing, Japan's economy is on the point of stalling then crashing. It is not hard to see why. Without bubble growth, the economy can neither justify nor sustain a level of investment equivalent to one third of GNP. But from this bloated level, any decline must have a profoundly deflationary impact. If capital spending falls by 12% over the next year, instead of rising at this rate as it has done over recent years, 4% points will be knocked off GNP growth instead of being added to it. A large proportion of such a fall will initially be offset by the rapid increase in Japanese trade surpluses. Prospects for Japan will therefore depend decisively upon whether its trading partners in Europe and America tolerate having their markets flooded by excess products which Japanese industry has been gearing up to make.

The logic of the present situation suggests that we are on the brink of a new period of endaka. Unless capital outflows are resumed on a significant scale, the growing current account surplus must drive the yen higher. The danger is the reverse. As the severity of the downturn becomes apparent, the present modest buoyancy in the stockmarket could evaporate. If the Tokyo index falls significantly below 23,000 – it is currently near 24,000, banks' reserve assets will be depleted and the credit crunch severify. This could bring more Japanese money home.

Under these circumstances, the obvious solution would be a rapid decline in Japanese interest rates. These leads one at first sight to a marvellously useless conclusion for the international investor. If asset prices in Japan are not to collapse further, they must be pushed higher. They simply cannot stay where they are today. The threat posed by powerful upward pressure on the yen can only be countered by opening wide the money supply faucet once more in the hope, to mix metaphors, of reflating a punctured balloon. This conclusion is not quite so marvellously useless to the investor as it seems. A marked fall in Japanese interest rates and an easing of credit would produce a bull bond market and probably some recovery in the stockmarket. As this would initially attract larger capital inflows than it would boost capital outflows, the yen still must rise. One can also conclude, beyond doubt, that any such stockmarket recovery would be a bear trap. It simply could not be sustained.

Given the choice between credit crunch and bear trap, the economic odds to me favour the latter. But beware. The political situation must also be assessed. Returning briefly to fundamentals, excess Japanese savings are unlikely to be eliminated without radical reform of the tax system, distribution system, agriculture, land ownership and use – all things which the American Administration has been demanding in the SII negotiations. It is equally clear that the present system of consensus government under a one-party system cannot deliver such reforms. I could explain in detail why what has been done to date has ducked all the issues (except in the field of financial liberalisation where the completion of interest rate deregulation is a ticking time bomb). It is sufficient to say here, however, that the reform of land ownership and use is impossible without substantially reducing asset prices (including share prices) relative to product prices and incomes. Such a reform must therefore involve a transfer of wealth from the one-third who own everything to the two-thirds who own next-to-nothing. No consensus could ever be reached to this end. Every section of Japanese society, which enjoys privileges under the present system, will fight tooth and nail to protect them. They can only be taken away, in the interests of the majority, by the disintegration of the omnibus LDP coalition and the emergence of rival parties representing sectional interest groups.

This process of disintegration began in the late 1980s with the Recruit Cosmos scandal. Don't for one moment think that the exposure and exploitation of this scandal was accidental: nor for that matter the Uno womanising revelations or more recently the Nomuragate scandal. All were deliberately exposed, and kept on the boil by a series of

fresh leaks, as part of two generational civil wars currently raging in Japan. The first is between tainted old politicians, aged 65 to 75, who control factions within the ruling LDP, and a younger generation of politicians, aged 55 to 65, who have controlled the Japanese Government and top ministerial jobs since Takeshita was ousted and Nakasone disgraced in 1989. The second is between top bureaucrats, aged 45 to 55, and their political masters. These bureaucrats, remember, are the radical student generation of the 1960s, many of whom remain dedicated to radical reform.

The tainted old politicians are the Taisho generation, born during the reign of the Emperor Taisho between 1912 and 1926. The less tainted, because none are faction leaders, young politicians were all born during the Showa era. Ever since they captured the party leadership in 1989 following the Recruit scandal they have monopolised all top Government jobs. This division between control of the party and the Government is without previous precedent in LDP history. The Showa generation wants to keep the premiership. The old faction leaders want it back. Their control over the money-bags, thanks to their links with top industrialists and financiers, gives them control over the party and hence the power to decide who becomes Premier.

The Showa generation must shoulder responsibility for Government policy. The economic situation and pressure from abroad oblige them to promote reform measures and such things as Japan's Gulf war contribution. The Taisho generation politicians stir up opposition to such measures behind the scenes. This is designed to pave the way for their own return to power.

Kaifu's success and popularity in Government has seen off the electoral threat posed by the Socialists in 1989. Consequently the LDP won a resounding victory in the April 1991 local elections. The old guard took this to mean they had been purged of their sins. Takeshita, without telling Kaifu, promptly orchestrated Nakasone's re-admission to party, The first Kaifu knew of this was afterwards from journalists. In May, Setsuya Tabuchi, Nomura's Chairman, told visiting British journalists that Kaifu would definitely not be given an extension as LDP leader this October. Takeshita, he said, would make a come back. He would see to it. Tabuchi and Takeshita have long been chums. They went to school together.

The Showa generation's response to this posturing was swift and effective. With the aid of bureaucrats in the National Tax Agency and the Justice Ministry, they leaked news to journalists of Nomura compensation payments and links with gangsters. The Nomuragate scandal was deliberately exposed to rekindle public hostility to money politics and to discredit Takeshita's powerful backers.

This stratagem seems to have succeeded. It is now quite likely that Kaifu will get a further year as Premier. The reason is simple. The latest list of names of people compensated by brokers in the year to March 1991 was sanitised. Sensitive names were omitted. If the Taisho generation seriously attempt to reclaim power this year, they will be leaked. The deal, however, is also likely to include the return of old faction leaders to top ministerial and party office.

Meanwhile, in the Diet, important legislation will be lost. The law regulating brokers may pass. But those reforming money politics and the electoral system, and allowing

Japanese troops to serve abroad on UN peace-keeping missions will probably be lost. This does not matter. With Kaifu's term extended, the legislation will be returned to the Diet.

Electoral reform, designed to eradicate money politics, will be blown up into a major public issue in the run up to the July 1992 Upper House elections. If necessary, further scandals will be exposed to speed its passage. There is no way the LDP and consensus can survive the move to single member constituencies combined with proportional representation. The stage will thus be set for a major confrontation between rival parties over the radical reform of Japan's economic system.

During an earlier period of great turbulence in Japan, following the arrival of US Commander Perry's black ships to force open the country to trade, the Tokugawa Shogunate faced the unpleasant choice of a foreign war it could not win if it refused, and civil war it could not win if it acquiesced. The LDP is in the same position today. It faces a trade war unless it enacts meaningful reforms, and a political civil war as it tries to do so. Whatever the short term prospects for the yen and the Tokyo market, growing foreign hostility as Japan's trade surplus surges once more, is bound to create domestic turbulence. I doubt that the Tokyo market can avoid moving to significantly lower levels.

My message to you today is clear. If you put money into Japan, gather ye rose buds while ye may.

EDITOR'S NOTE

On the 5th November 1991 Japan's New Prime Minister, Kiichi Miyazawa, a member of the 'Taisho generation', announced his new cabinet – with 8 leading posts going to politicians aged over 65. Since that time there have indeed been numerous unattributable leaks in Tokyo embarrassing the Prime Minister with revelations on scandals old and new.

On the economy side, evidence continues to build of a slowdown in capital spending and Tokyo increasingly worries over lowered projections of economic growth for next year.

Meanwhile, as a 'straw in the wind' one can report that Tokyo taxi companies have asked for (and are likely to get) a 19% rise in fares this year on top of a 9% rise last year. But all bets on inflation could still be off if the Yen were to be allowed a substantial rise – as is surely justified by the trade figures.

And discussions with knowledgeable Japanese to whom the paper has been shown have confirmed, usually without any dissent, both the line taken and the conclusions drawn. As one official from Japan's Long Term Credit Bank put it, "To ease the damage done by a period of economic mismanagement, we need another period of economic mismanagement". This means that the stand against expansion will be held as long as possible in the effort to reduce asset values, but that there will come a point – perhaps in 6 months or a year's time, when the stress of this will outweigh the costs – and then a switch will be made.

Meanwhile, Japanese (and foreign) fund managers in Tokyo are in the difficult position of having to publicly predict no real change in the Yen's value in order to encourage ongoing client business whilst at the same time eagerly awaiting a major rise which would signal 'go' for an avalanche of deals!

But against all this, Japanese make some criticisms of Brian Reading's position, on the basis that he has possibly underestimated the chances of a rising Yen and a major resumption of outward capital flows to ameliorate the problem.

Tokyo, December 20th.

UNEMPLOYMENT: A REAL SCOURGE

By Sydney Shenton

In human terms, with employment comes hope, purpose and self esteem. With loss of one's job comes shock, resentment, and humiliation. There is deep social damage and in economic terms a shameful waste of resources. More and more money – very sizeable figures, are being spent on training schemes and the like particularly to keep the young occupied, and whilst this is better than nothing it is far from getting to the root of the problem.

Mass unemployment demands treatment as an issue in its own right, but instead it has been treated as a byproduct of other problems or still worse, as a means of reducing inflation – "A price worth paying" said the Chancellor. This is most objectionable. It flouts all decent political traditions, including 'one nation Conservatism', by treating millions of our fellow men as things and means, not as ends in themselves.

To say that unemployment is something we have to put up with, for which the country must suffer pro tem, to justify some problematical improvement in the economy as a whole in due course, is totally indefensible. The 'country' does not suffer across the board in any event. The men and women who bear the brunt come from the poorest sections of the community. The well-to-do escape comparatively unscathed. It is all such a dreadful unnecessary waste. The nation as a whole, and the very unfortunate people concerned, need not have suffered anything like as much if better aims and properly directed policies had been introduced. To say, in line with current Conservative ideology, that unemployment is a necessary consequence of the need to permit open market forces to work, and that there is little that can or should be done about it in the creation of work opportunity, is a defiance of commonsense and responsibility.

We are aware that the world has had to deal with a nasty recession, but all the evidence shows that we have coped far less successfully than others. The problem is difficult but with the resources and powers at its disposal the government could have done much, much more. Policies are not simply natural in character. They can promote industrial change and in all sorts of ways boost employment without any serious harm to inflation. Public works, reconstruction, transport systems, many other much-needed projects could have been organised instead of paying so much to so many to do nothing. Instead public spending here has been squeezed more than in any other industrialised country. Only Britain is spending less as a percentage of GDP than it did in the late 60's. It is illogical, and, given the needs of the country and the people, utterly disgraceful.

In this context huge salaries and awards have been gathered in at the top so that the division between the highest and the lowest earnings has increased continuously. The well-off, in the main, can afford to take a detached attitude and, against all the evidence claim, under the fashionable supply side theories, that wealth will trickle down ...

As the benefits both to individuals and the economy as whole are conspicuous by their absence, it is extremely difficult to understand how the Prime Minister can state that, when adding estate duty relaxation to this doctrine, the undetected trickle will turn into a cascade.

This attitude is reminiscent of what Engels observed in Manchester a century or more ago. "I walked", he said, "through the streets and commented about the unhealthy slums and the disgusting conditions in that part of the City in which the factory workers lived. He listened patiently and at the corner of the street as we parted company, he remarked 'And yet there is still a great deal of money made here ... Good morning Sir.'"

We know now full well that our relative economic decline is long term and undeniable. The tide has not changed since 1979 as was hoped and claimed in the middle Thatcher years. There are many interacting reasons, some detected by Alfred Marshall whose study was published as a White Paper in 1903. "Many of the sons of manufacturers exert themselves far less than their fathers did. They work much shorter hours. If Englishmen do not take business as seriously as their grandfathers and as the Americans and the Germans are doing now, and are not training as methodically and keeping as up to date, the country is bound to experience serious problems."

Marshall was opposed to theories that projected the best outcome from a totally free market. Matters and development had moved on somewhat from Adam Smith. He disliked socialism but thought the then inequalities of wealth excessive. He would most certainly have thought the same today.

Many of our great men have thought full employment a worthy objective in its own right. Keynes wrote in 1914, "When money can be spent on capital improvements with a large part going in payment of labour which might otherwise be unemployed the argument for instigating capital works must be very strong". Winston Churchill said in 1925, "The country lacks goods and facilities and millions lack work. It is the highest function of national finance and the government to bridge the gap between the two. There must be a connection with the prevalent British phenomenon of chronic unemployment and the long consistency of particular financial policies". And Harold Macmillan stated in 1938, "The important thing is that society should be organised in such a way as to bring the economic system under conscious direction and control so that increased production can be directed towards raising the standards of comfort and security for all of the people".

Society does in fact exist – and imperfect markets produce imperfect results. Policies may not always be right – as we have discovered with over-enthusiastic nationalisation,

but responsibilities should not be evaded. All too often, as Joan Robinson commented in 1937, "It is the Economics of Imperfect Competition that rule the Roost".

For two years or more (1980/1) the Conservative government treated monetarism not as one economic theory amongst others ("there is no alternative") but as an incontrovertible principle like the law of gravitation. Our exchange rate was pushed up to unsustainable levels, we were priced out of a huge tranche of our export markets, we induced a damaging recession, a significant portion of our industry was killed off, and unemployment rose to levels never experienced since the grim thirties. All this had to be undergone before the theory was abolished and replaced with the new fashionable supply-side policies holding sway in the U.S.A.

At first the improvement led to the belief that we had worked an economic miracle. Then came disillusion, the theory was found to be fallible, and the practice faulty. The Lawson '88 Budget was the biggest error of all, because it stoked up the credit boom and inflationary pressures, sucked in imports, created extreme social division and all in all created as much havoc in its train as has Professor Friedman's monetarism. As is to be expected, Milton Friedman still maintains that his theory is akin to scientific certainty, and that only the application was faulty – despite the fact that he could have hardly had a more convinced disciple than Margaret Thatcher! It is ironic that Keith (Lord) Joseph said at the time "I agree that there are limits to the good which Governments can do, but no limits to the harm".

High unemployment and all that it involves if it persists, must be a sound reason to change policies. We suffer a staggering loss of income due to unacceptable levels of unemployment. There has to be balance and constant correction of error if the results are not to be damaging and unproductive. Our tunnel vision of inflation to provide the solution to all our difficulties has brought us to the situation that extreme deflationary policies have inflicted economic damage in themselves.

Deflationary policies weaken the supply side of the economy, taking men and capital out of use; so that when the upturn in demand at long last comes it cannot be responded to adequately, thus making the return of inflation much more likely. In the long hard road back to full employment, if ever we can start upon it, there is a limit to what we can accomplish.

International relations and co-operation play a vital part, and our trading and financial systems are inextricably linked with the rest of the world in general and with Europe in particular. That is why our future relationship with the EEC is so important. Nothing would be more stupid than to permit short term electoral political matters to damage this. I believe that membership of the ERM was most necessary and that the move has brought many advantages including stability, but the evidence is undeniable that we went in at too high a rate. Our exports have been severely limited by this overvaluation and once having committed ourselves adjustment is difficult due to political and other constraints.

We need to take the first opportunity for realignment, without regarding to party political face. The Governor of the Bank of England has opposed this, saying that there is one important word above all others ... "stability". But there is not the slightest chance of any kind of stability unless unemployment is brought down to a tolerable level.

Conservatives, many recall, used to be able to throw off the tyranny of theory and political pride. They used to be able to recognise the facts and adapt and change the policies, and if necessary the institutions, to preserve social stability and improve the national and their own political prospects. John Major has proved adaptable and willing to change in this way – in most areas except the most important, the economic field.

R.A. Butler said in 1980 ... "There seems to be a temptation to go back to the nineteenth century in search of allegedly eternal truths, instead of adjusting our ideas to changing realities. It used to be the boast of Conservative governments that they looked after those least able to look after themselves and those hit by economic forces beyond their control. We have done so because of our belief in national solidarity and our sense of community". At the commencement of Mrs. Thatcher's premiership there was reason to hope these ideas would be put into practice. She herself said at the time "Human dignity and self respect are undermined when men and women are condemned to idleness. The waste of a country's most precious assets, the talents and energies of its peoples, make it the bounden duty of government to seek a real and lasting cure". Our new Prime Minister has voiced similar ideals and sentiments. The time is long overdue for effective, even if risky, deeds – not simply words.

THE EDWARD HOLLOWAY COLLECTION REVIEW

The Uncertain Ally 1971–1957 by John Biggs-Davison, M.P.

Published by Christopher Johnson, London 1957

Ten years ago I met John Biggs-Davison over a cup of tea enjoyed on a sunny afternoon in Edward Holloway's garden in Brighton. They had been personal friends for a long time and I was not surprised to find this book in the collection.

John Biggs-Davison was no conspiracy theorist nor extremist. He stood by his country and believed that the British Commonwealth had enormous potential. Quite proper aspirations and perfectly normal patriotism had been betrayed and ignored repeatedly during his political lifetime and he saw the influence of the United States bearing much of the blame.

It would seem not at all irrelevant to remind oneself that quite recently Enoch Powell has been making similar suggestions – especially with regard to the EEC.

So "The Uncertain Ally" takes us from America's entry to the 1st world war through to Britain's debacle at Suez. America emerged supreme from WW1; the 1920s and 1930s were times when attempts were made to strengthen Commonwealth economic development through trading arrangements; the 2nd world war saw America's influence and strength further expanded; arrangements after the war saw Britain crippled with debt and exchange rate problems, and then, in 1956 Britain was told that in America's

new world order, there was no place for our forces at Suez or indeed anywhere east of Suez. Throughout, it was a picture of decline for British influence and missed opportunities for a Commonwealth whose members, whenever asked, had shown themselves willing indeed to shoulder common problems and goals. But the mirror image of this decline has been the rise of America. Is America truly Britain's ally?

Politics and war aside, Biggs-Davison saw economic policies as fundamental to national strength. Here he is a Tory in Disraelian mould. For him, economic policies should aim at nurturing and sustaining jobs, investments, trade and development. One should foster industries by protecting them against the unexpected and the unfair. Businessmen should be given a climate of optimism, security and assistance within a large enough market to sustain economies of scale and adequate research and development. They should not be exposed to unfair competition from firms located in countries whose protective barriers and subsidies cannot be matched. In that direction lies only the growth of one nation's dominance at the expense of the standard of living elsewhere – a very different concept from laissez-faire and Manchester school free trade.

GATT and free trade – and the moves in that direction between the wars – contain a fatal flaw in his view. Freedom of trade *between* nations is promoted without taking account of trade practices *within* nations. Both America and Russia – the inland empires, practised protection within their borders – that was not an 'international' matter. But the Commonwealth, a body similar in population size was told by America that any trade concessions given to members must be extended to all because such trade was 'international'. This is what the use of the "Most Favoured Nation Clause" meant and it threw the economy of the Commonwealth to the wolves. Ultimately, the English speaking world had to become, by this route, satellites of America. Every time Britain needed American help she was told that this would be on condition that Imperial preference, Commonwealth preference, the Sterling area etc. must go.

Woven into this picture is an account of the many strands of American thought that have assisted 'British Commonwealth or Empire bashing'. It is easy for American politicians to play on the original anti-colonial establishment of the USA – a notion that very conveniently ignores the fact that the net effect of this move was merely to replace London with New York as the colonial headquarters for expansion to the West. The simple notion of 'democracy' has also played its part. We are beginning, only now, to realise that the democracy, far from creating political emancipation, has just replaced the older set of power holders – the Aristocracy – with a new one – the 'Opinion Formers' of the press and media who can 'move' public opinion to whatever cowed politicians are bidden to do (the recent dismissal of Margaret Thatcher being an interesting case in point). Japan, incidentally, has not gone this way; the old aristocracy has become the Civil Service and still runs affairs, to evident advantage and to the shouts of 'antidemocratic' from the Japan-bashers.

But such simplistic notions of history, of free trade, of democracy have forced Britain to relinquish colonies naked of preferential access to the British and other Commonwealth markets and has prevented New Zealand, Australia, Canada and South Africa from pursuing together with Britain a coherent, constructive, mutually supportive process of economic expansion and development.

The results in Britain and elsewhere in 1991 surely justify Biggs-Davison's criticisms. But in 1991, there is a ironic point to add to the tale. The very practices which America used to unseat Britain have been adopted by Japan and self righteous America is stuck with the propaganda it has espoused for so long.

There is much more. What were the real motives for the United Nations? Was the surprise at Pearl Harbour unexpected in Washington? Why did we really return to the Gold Standard? But these are all stories in themselves which one must leave the reader of this useful account to discover for himself.

J.B.

COMPETITION OR CREDIT CONTROLS?

By David Llewellyn and Mark Holmes
Institute of Economic Affairs, Hobart Paper 117

This instructive lengthy duograph sets out to demonstrate that the deregulation of banking and finance of the 1980s now provides a more efficient framework for the allocation of the nation's capital resources than was previously provided under a system of credit rationing or that could be provided under any foreseeable system of credit control.

It very usefully demonstrates that even major changes in housing finance would now make relatively little difference to the overall picture and also that the credit excesses of 1987 were a 'once and for all' result of the shift in policy rather than an inevitable and recurring effect of liberalisation.

The policy implications for the future are simply that the present position should be little tampered with – either by British authorities or under the auspices of 'Europe'.

As a static micro analysis the book is admirable but it does seem to ignore certain dynamic macro effects – the cumulative movements of expansion and contraction in the demand for credit. As waves surge and recede quite extraordinary changes in interest rates may be needed to allow market mechanisms alone to control events, and these changes would have devastating effects on capital values and on international lending disrupting the construction industry, public infrastructure development and international trade – to say nothing of ordinary household finance. Something surely is needed to preserve stability. And surely it cannot be right to entirely ignore the seignorage effects of non-interest bearing deposits – of bank accounts bringing benefits to banks and of notes and coins which should bring benefits to the State.

But at least it is very valuable to be talking in terms of 'credit' rather than 'money supply' if, in reality, they are much the same thing. After all, nowadays the growth of the money supply amounts to the growth of acceptable credit requests made to banks plus the issue of notes and coins which are credits given by individuals to the Government. To be told by the financial press that "requests for credit are up" may be more meaningful than to be told the depressing news that the "money supply has increased". To be told that the level of savings does not allow all of these credit requests to be granted may well be more instructive than to be told that we must "control the money supply". And such a change in nomenclature brings us closer to understanding the real powers – and limitations of the banks -since those with credit requests unmet have, in todays world, alternative sources to turn to.

J.B.

THE END OF THE DOCK LABOUR SCHEME.

By Iain Dale
Published by Aims of Industry, 40 Doughty Street, London W.C.1. Price £3.50.

In this 20 page booklet an early but nonetheless welcome appraisal has been made of the effects of ending the Dock Labour Scheme. It is an important example of successful liberalisation and a move in line with current government policies which will not be overlooked abroad. This useful and timely little contribution to the annals recording the successes of Adam Smith is recommended as a case study for all those involved in teaching or studying policy developments.

J.B.

LETTERS

A response to Britain's educational system: The lessons of history by John Black, from Mr John Hatherley.

Sir,

A former teacher, I read the views of Professor David Bell and Correlli Barnett, and Mr John Black, with interest and sad agreement.

I remember the shock one day in the 1960s, teaching in a Voluntary Aided grammar school in Wimbledon, when I suddenly realised that, in effect, what my dedicated colleagues and I were doing was turning into third-rate clerks many of the boys badly needed to lead on Britain's factory floors – with sad personal consequences for these young men, and later, their young families, because of personal talents undeveloped.

Yes, as emerged from the Bryce Commission Report nearly a century ago, our education system is too academically orientated. "Engineer" is almost a dirty word. Yet education should involve primarily the development of individual talent, along with some appreciation of literature, the arts, and good manners. A mere glance at British history reveals those talents. Indeed, some of our universities are the envy of the world.

Lloyds showed astuteness in drawing on honest and shrewd East End lads and training them; but what interest has industry and commerce shown, in collaboration with government initiative, to contact young people at the enquiring age?

Yes, we do need the system in operation in many West German states – discussion with parents, teachers and pupils at an appropriate age as to which type of school individuals should attend to pursue further education. But class attitudes are different in Germany.

If memory serves me correctly, both our President and Harvey Jones of ICI have expressed similar sentiments; the question is, how can we of like mind induce government and industry to resolve this crisis soon?

Yours faithfully
John Hatherley
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Inflation and unemployment: A response to *Back to Phillips* by Mami Kajikawa and Jim Bourlet, from Mr Henry Haslam

Sir

There is another way of looking at the data discussed by Kajikawa and Bourlet in the autumn 1991 issue.

If inflation and unemployment for the period 1970-1992 are plotted against time (Figure 1), it can be seen that high inflation is followed, a year or two later, by rising unemployment. Unemployment falls after a period of lower inflation.

Figure 1

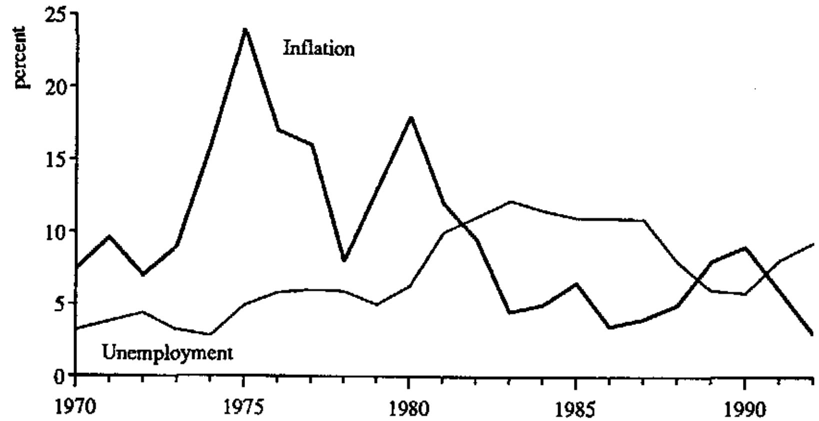
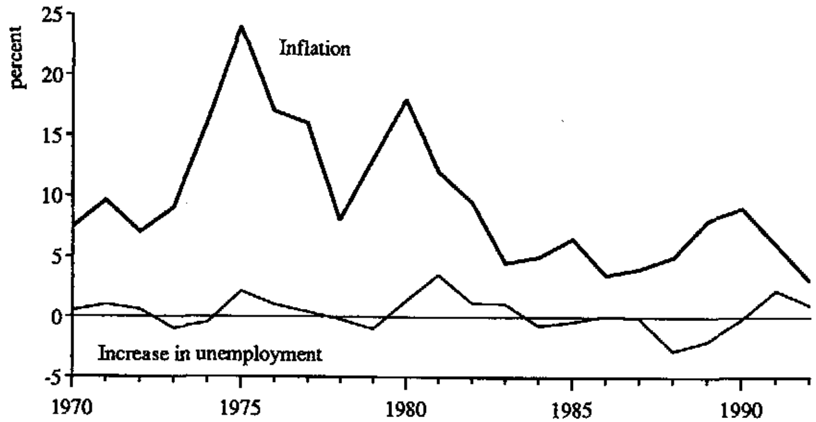


Figure 2



This relationship is demonstrated more clearly in Figure 2. The way that unemployment and inflation are presented in Figure 1 does not allow a direct comparison to be made between them: inflation is expressed as a year-on-year change in the value of money, whereas unemployment is expressed as a cumulative figure. If the unemployment figures are recalculated to show the annual change, the resulting graph (Figure 2) compares the year-on-year increase (or decrease) in the percentage of the workforce out of work with the year-on-year percentage decrease in the value of the pound. This graph shows very clearly that high inflation is followed by a rise in unemployment and low inflation by a fall in unemployment. There is a striking parallelism between the two trends, with a time gap of a year or two.

It seems that what happens is that high inflation makes people anxious about a declining standard of living and this leads to disputes and high pay settlements. And when people expect or receive a higher level of pay than the market for their output will bear, the inevitable consequence is rising unemployment (see ERC Occasional Paper No. 43). Conversely, when inflation is reasonably low, as in the mid 1980s, pay rises are in line with what the demand in the market will bear and unemployment falls.

And what of the Phillips curve? Because of the delay between a change in the rate of inflation and the consequent change in the level of unemployment, there are times when one is rising and the other falling, as in the Phillips curve (see Figure 1), but this is because the trend in unemployment reflects an earlier trend in inflation, not the present trend. When there is a sustained increase in inflation, there may be an improvement in the unemployment situation for the first year or two, but thereafter (as in 1975, 1980 and 1990) the damaging effect of inflation on unemployment becomes apparent. Similarly, a sustained decrease in inflation may at first be accompanied by rising unemployment but after a while, if inflation continues low (as in the mid 1980s), there is an improvement in the unemployment trend.

It is therefore seriously misleading to suggest that there is a trade-off between inflation and unemployment. The experience of the last twenty years has shown that if Government wishes to achieve lower unemployment it should ensure that inflation remains low.

Henry Haslam
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A further response to *The proposal for a basic income of £4000 per head, financed from an energy tax* by Mr John P.C. Dunlop, from Mr Christopher Havergal

Sir,

Referring to John Dunlop's letter on page 16 of Britain and Overseas, Vol 21, No 3, I would like if I may to shake his hand across our military linkage, for the ideal of service that inspires and animates our two armed services provides a near perfect model for prosperous economy; namely, the supply of manhours productive of military efficiency is matched by the rate of flow of British currency units necessary to attract that supply and to carry it away to the people who demand it. If the Royal Navy and the Army were closed Economies their currency units could obviously be given military manhour standards of value.

To enlarge the scale to national Economies, true prosperity demands that every available able adult shall be motivated to devote about a third of his lifetime to providing his neighbours with what they want or need when they want or need it. The remaining two-thirds being divisible between personal fun and games and ploys, and sleep. If the neighbourly third flows with a will, the community will be prosperous beyond imagining. But if the neighbourly third has to be ground out under the rollers of greed at all levels in the relevant Economy – as in ours at the present time – the gleams of prosperity are fitful and illusive indeed. Prosperity is therefore the flower more of moral motivations – such as loving and therefore working for one's neighbour, as oneself – than of politics or economics.

Regrettably, as so often happens with published correspondence, it is clear that John Dunlop and I have been writing at cross purposes. He wants to see taxation reformed; I want to see money reformed, so that monetary units may attain and hold constant purchasing power, no matter what politics and economics may do with it. I hoped I had made this clear mathematically in my former letter in a way which I feel sure the editor will not allow me to repeat here. I hope however he will permit me to amplify it now with the following three observations:-

First; I am convinced that all economists should come to accept that the only absolute-value commodity known to community man is the average of the input of productive manhours per hour which pass through his Economies; for without this flow there can be no wealth at all since there then could be no economy at all. As stated above when productive manhours flow freely and with a will there can be wealth and prosperity beyond avarice, especially when productivity is augmented by fuels and sophisticated tools.

Secondly; I hold that the rate and volume of money supply (i.e. currency flow) must be kept rigidly in step with the productive manhour supply, if constant purchasing power currency is to be sustained (e.g. the £ should be given an easily calculable realistic MANHOUR STANDARD OF VALUE, so that its flow rate can be accurately held in step with the productive manhour rate). Can anyone really doubt that when inflation bites the only civilised cure is for industrial captains and their teams to charge less – not more – for their productive manhours? Yet in Britain at the present time we have the inglorious spectacle of far too many of our industrial captains leading the field in vying with the trade unions to prize out often grossly above inflation rate salary and wage increments, thereby promoting both inflation and unemployment for all their neighbours.

Thirdly; questions of what is to be done with constant purchasing power currency when we get it will of course be the subject of endless political and economic debate. John Dunlop's advocacy of Unitax could then be fitted in without risk of adding to inflation.

In view of the above remarks he, John Dunlop, will not be surprised if I emphasise here that I am one hundred percent opposed to his somewhat amorphous Norbert-Werner statement that: "In all important respects the man who has nothing to sell but his physical power has nothing to sell which is worth anyone's money to buy"; for not only can there be no such economic man, but, understood in the statement's broadest sense – as I have attempted to show above – the sale of a man's physical powers (i.e. the product of his mind and muscles) per unit of time is in fact the only commodity anyone ever buys. For support consider the valueless gold in Mars!

Yours sincerely,
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