BRITAIN & OVERSEAS

A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY
AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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GLOBAL AND UK ECONOMIC PROSPECTS IN THE 1990S

Summary of a talk by David Kern,
Chief Economist and head of Market Intelligence, National Westminster Bank
to members of the Economic Research Council on 27th October 1992.

Geopolitical background

The momentous changes in the geopolitical scene in recent years have produced very serious transitional problems, which are far from being resolved. Nevertheless, the basic elements of a "new international order" are in place. These are:

- The ending of the cold war.
- The emergence of the US as the only genuine political and military superpower.
- The growing economic and financial influence of Japan and the EC.
- The exit of Eastern Europe from the Soviet orbit and the democratisation of the area, coupled with pockets of ethnic conflict in places such as the old Yugoslavia.
- The collapse of the former USSR, growing tensions between regional powers such as Russia and Ukraine, and increased risk of ethnic disintegration and tension.
- The unification of Germany.
- The destabilising effect of Islamic fundamentalism in North Africa and the Middle East.
- Western Europe's move towards economic and monetary integration, although the region still faces considerable internal tensions, as well as basic choices, in key areas: political union, trade, defence, foreign policy and relations with the US.
- The increasing fragmentation of the global trading scene into rival regional blocs, which will continue even if the Uruguay GATT round produces an agreement.
- Growing environmental pressures and costs which will have a major impact on economic and political decisions.
- Radical restructuring during the 1990s in a number of industries and business sectors including financial services.

The world economy

Trade

- The agreement likely to be reached in the Uruguay GATT round will satisfy only some of its original aims. Therefore, GATT's efforts to sustain the momentum towards multilateral and nondiscriminatory free trade will have only partial success.
- The global trading scene will become more fragmented, as powerful economic and commercial blocs consolidate in Europe, North America and, in due course, in the Far East. The fragmentation could spread to other regions such as Latin America, Eastern Europe and South Asia.
- There will be no outright trade war, but tensions between major blocs will grow. Trade will grow faster within regions than across regions.

- Growth in foreign direct investment will be faster than expansion of international trade, and investment will remain the driving force for spreading wealth.

Growth and inflation

- The current recession is not a 'normal' business cycle downturn. The excesses of the late 1980s have led to an overhang of very high private and public sector indebtedness, overvalued property and other asset prices which seem set to continue falling, budgetary pressures and low consumer confidence.
- My central forecast is for below average growth, in a more stable but subdued economic environment, with less cyclicality. Governments will be concerned to avoid a repeat of massive debt accumulation and, together with adjustment to the financial problems inherited from the 1980s, this will restrict OECD growth to little more than 2% per annum in the medium term. Growth will be particularly low in Western Europe, with the EC averaging only 1.8% per annum over the next five years.
- Inflation will be modest, averaging some 3.5%–4% in the OECD area over the next few years. This means that the current sizeable debt overhang will not ease as rapidly as under faster inflation, but inflation at even 3.5%–4% will nevertheless permit a slow easing in the debt burden.

Interest and exchange rates

- Real interest rates in the OECD area will remain positive in the 1990s with average real rates in most industrialised countries within a range of 2.5%–4.5% during the first half of the decade and 2%–3% in the second half. This pattern of relatively high, but gradually declining, real interest rates will reflect the following factors
  (i) a continuation of anti-inflation policies; and
  (ii) the demand/supply balance for funds between investment and savings in the global economy.
- As inflation and interest rate differentials narrow, the global exchange rate scene will become less volatile than in the 1980s.
- The US dollar will continue its recovery, reflecting a gradual change in the current abnormal pattern of interest rate differentials (with dollar rates exceptionally low), and a correction of the dollar's significant Purchasing Power Parity (PPP) undervaluation.
- To summarise the global scenario, and introduce the UK into the discussion, we should remember that although people regard growth of 2%–3% as the post-War norm which they expect to continue, in previous centuries stagnation was in fact more common than steady growth. So where do we find ourselves now? Are we going to see any resumption of growth at all; or, are we in a new "ball game"?
- An important question in relation to the current recession is whether it is simply part of the normal cyclical pattern or whether the legacy of the 1980s, the excesses of private debt and public sector debt (to a level virtually precluding an expansion of government expenditure) and of job insecurity problems, have created a new situation in which the pessimists see a downward spiral with no real prospect of an upturn. My own view is that such an assessment may be too pessimistic. A more realistic expectation would be low, below par growth over the next few years, with unemployment remaining relatively high. This fundamental point is equally valid for the OECD as a whole as for the UK.

UK economic prospects

- As already mentioned, I do not believe that there will be a downward spiral over the next few years; but neither do I believe that the present recession is a 'normal' one. A plausible forecast must recognise the powerful combination of negative factors mentioned above and the fact that increased productivity and new technology will mean that the effects of this cyclical downturn are not confined to manufacturing. This time, there will also be big increases in unemployment in the services sector in general, and among the professional middle classes in particular. In my view, we will see a slow recovery in output over the next four to five years coinciding with high unemployment levels, and large companies, where technology will be generating steady and rapid productivity increases, will continue to drive out middle managers. This is likely to affect the very nature of society – corporations will create wealth, but not jobs. The new jobs that are created will be mostly in small business areas.
- The UK economy was in relative decline up to 1980. Mrs Thatcher appeared to have reversed the trend. Indeed, much changed for the better in the 1980s in terms of a better management style, a more competitive business environment and significant improvement in productivity. But now in 1992, the old UK "sickness" seems to be recurring and we are back to the core dilemma – growth and employment versus inflation and a large balance of payments deficit at a time when the weak economic cycle should be generating surpluses. This dilemma has proved divisive in the Conservative Party in relation to wide areas of economic policy, and Britain's attitude to the EC in particular.
- Following "Black Wednesday" (16 September the date of sterling's forced exit from the ERM), securing faster growth is again a primary policy objective, with sterling's 12% effective devaluation, a 3 percentage point reduction in interest rates, and fiscal support for key sectors in the Autumn Statement – measures that were all designed to boost growth prospects.
- Lower interest rates and a weaker pound will take time to impact on activity. The economy will remain flat in Q4 1992 and Q1 1993 and will then start a modest recovery, as low interest rates strengthen both consumer confidence and corporate liquidity. The company sector will also benefit from a highly competitive exchange rate and very low unit labour costs. GDP is forecast to expand by 0.7% in 1993, with growth rising to 1.8% in Q4 1993 and averaging 2% in 1994. Medium-term growth averaging 1.9% will be below the long-term trend, but will nevertheless exceed the EC growth rate of 1.8%.

- The UK housing market is still weak but house prices have now fallen back to their pre-boom levels in relation to earnings, and will start edging up slowly in Q2 1993.
- Despite reduced financial pressure on companies and the resumption of output growth next year the need to rebuild company profitability will result in further increases in unemployment, towards a peak of 3.25m by end-1993.
- All-items RPI inflation will fall below 1% next Spring, as mortgage rate reductions depress the index. Underlying RPI inflation, excluding mortgages, will decline to just under 3% in April, reflecting lower earnings growth. Both inflation measures will start accelerating towards end-1993, as the effects of sterling's devaluation feed through. In 1994, all-items RPI inflation will average 5.8% and the underlying measure 5%. However, with the economic growth remained subdued, and a return to the ERM discipline likely during 1994, I do not think inflation will get out of control. I expect UK inflation to average 4% per annum in 1993–97.

Conclusions

- The 1990s will be a period of subdued below-average growth – both internationally and in the UK – with inflation remaining modest but definitely not falling to zero.
- Interest rates in nominal terms will be lower in the 1990s than in the 1980s; but they will be positive in real terms, and the policy stance will be sufficiently prudent to preclude a prolonged upsurge in inflation, although permitting some temporary easing to counteract the recession.
- Among the major economic regions growth prospects appear most promising in the US and this will underpin a stronger dollar. Conversely, the EC, and Germany in particular, will be economies with below average growth.
- In Europe, although the Maastricht timetable will prove unrealistic, the process of further integration will slowly continue. The UK will face difficult choices, but the cost of staying outside a powerful trading bloc created by the core European economies will prove too high, and I believe the UK will ultimately join the process and become a core country of an enlarged EC in which the process of economic and monetary integration will move forward over the next 10–15 years.

THE MODERNISATION OF BRITISH INDUSTRY

Summary of a talk by Sir Geoffrey Owen, Director of the Business Policy Programme at the L.S.E. and former editor of The Financial Times, to members of the Economic Research Council, on Tuesday, 24th November 1992.

Britain is in a deep recession and there is anxiety about a worsening industrial slump. There are fresh calls for an industrial strategy, a new partnership between industry and

government. There are many reasons at this time to feel gloomy. Nonetheless, without in any way minimising the importance of the present recession, I want to put forward the view that over the past 15 years there has been a substantial modernisation of British industry. I'm certainly not suggesting that all our problems have been solved – levels of productivity, though much better than they were, are still below our strongest overseas competitors in several industries. But it is important to recognise the change that has taken place, and then to consider how to build on it.

The post-war period can, rather arbitrarily, be divided into three periods:

i) 1945-1960
ii) 1960-1975
iii) 1975-1990s

I will not dwell too long on the first of these periods. It seems to have been a period of relative complacency during which markets seemed easy and imports were limited in scope. There was pressure to produce more rather than more efficiently. Industry made concessions to trade unions and accepted bad working practices. Government got its priorities wrong. For example, in 1958 Prime Minister Macmillan made the judgement of Solomon in deciding on the location for Britain's new steel strip mill – he divided it between South Wales and Scotland – so that neither could achieve the available economies of scale. His priority was to keep regional pressure groups happy, not to promote efficiency, and that decision dogged the industry for thirty years until the eventual closure of Ravenscraig.

The second period began with a period of national self-analysis, with the government looking for ways of improving performance, for "magic cures" such as French style indicative planning, or Italian style state holdings companies, or US style business schools. During the second half of the 1960s business felt the start of greater international competition such as the challenge from Japanese motor bikes.

Unfortunately our reactions seem in part to have gone in the wrong direction. The European-wide tendency to emulate all things American was carried to extremes in Britain. In imitation of G.M. we tried to consolidate all British owned motor companies into British Leyland. Likewise Courtaulds aimed at vertical integration in textiles – a technocratic solution based on economies of scale to the neglect of the customer. The attempt to be a low-cost supplier of standard fabrics based on high investment and high volume, turned out to be the wrong way of tackling the industry's problems.

Meanwhile, other companies such as GKN, Tube Investments and Thorn, built large diversified empires, a process that distracted attention from the need to make the underlying business more competitive and concentrate on their core businesses. I believe that these mistakes were made because the competitive pressures were still not all that great. Right up until the oil crisis and the world recession of the early 1970s, our traditional export markets remained buoyant. We could pursue an unrealistic policy of creating national "champions" such as ICL and maintain illusions of being a great power.

But from around 1975 onwards – my third period – there has been a tremendous intensification of world competition involving:

i) Entry into the EC. A rapid rise in car import penetration was an early result of this.
ii) The rise of Japanese competition in such industries as TV sets and motor cars.
iii) Slower growth in world trade, including the collapse of some traditional markets.

These developments put manufacturing companies under great commercial and financial pressure. They had to make themselves more efficient – or go under. Hence there was an attack on overmanning and restrictive practices. Michael Edwardes was a pioneer at BL and others, such as British Steel, followed. There was re-orientation of corporate strategy to ask the question "Which of our businesses, if any, can be made internationally competitive?". Thus GKN hived off peripheral assets and focussed on vehicle components, TI reduced its business in aluminium, bicycles and domestic appliances in order to focus on specialised engineering. The theme was internationalization and specialisation. For Courtaulds this meant unscrambling the conglomerate. It meant a modernisation of management to those better qualified with more vitality, more attuned to international competition.

There were casualties in the transition. Some businesses had fallen too far below international competition to be saved. Revival depended on how well they had been managed in the 1960s and 1970s and whether they had a competitive advantage that could be built on. Some companies, such as Alfred Herbert were to disappear, others sold out as did Dunlop tyres to Sumitomo and yet others found partners as Rover did with Honda.

Some might ascribe our slow adjustment during the first two periods to historical factors or to winning the war but I prefer to put more emphasis on market considerations – competitive pressures and market opportunities. Perhaps the Commonwealth was an "easy option". Leyland Motors soon after the war deliberately avoided attacking markets which had their own indigenous industries, such as Germany. This was not an irrational decision and Leyland was seen as one of the great export successes of the 50s and 60s but it made the eventual switch to the European market all the harder. Our position was quite different from the Continentals who traded mainly with each other. Indeed, the 1960-75 period was important in the modernisation of European industries and it is instructive to compare say, Renault with BMC in the 1960s. On entering the EC British companies faced rivals who were very solidly entrenched.

So now, how well integrated are we into the world market? What are my grounds for optimism?

I want to note two aspects of this. First there has been a growing internationalization and specialisation among indigenously owned firms. And secondly there is the growing importance on non-British firms in such industries as cars and TV sets which has helped to reverse our decline.

And should we fear this inward investment on the grounds that we might be losing

control over strategic industries? I feel that the "strategic" designation is not helpful – pharmaceuticals are never seen as strategic but rank amongst world successes. Let us briefly consider our position compared to others on computers and semiconductors. Britain now has ICL linked to Fujitsu plus big inward investment from IBM and we produce specialist semiconductors. France has subsidized Bull, SGS and Thopson while Germany has lossmaking subsidiaries inside Seimens. Now it is not at all obvious that our situation is worse than France or Germany.

Thus whilst it is easy to talk ourselves into a state of extreme gloom, even a mood of self-denigration with Britain as the sick man of Europe, I think that the true perspective of our industrial performance should reflect our achievements in adjustment and integration. That is why I am optimistic about the future of British industry.

A LITTLE MANAGEMENT, OR A QUESTION OF SOVEREIGNTY

A Philosopher's Perception of Money, the Gold Standard and the ERM
by Martin Pot

Those of us who, from curiosity or for some practical reason, attempt to acquire some knowledge of economics have little difficulty in understanding the basic laws of supply and demand. It is not hard to find examples in everyday life which explain movements in price in accordance with these laws, such as cold weather sending up the price of vegetables. We feel reassured that this part of economic theory is rooted in fact and that our feet remain firmly on the ground.

But it is quite a different matter with that other branch of economics, monetary theory (or monetarism as it is now mistakenly known). We find ourselves confronted with obscure and seemingly meaningless statistics such as M0, Sterling M3 and many others which one hardly dares mention for fear of turning off the reader. Any feeling of easy comprehension we may have entertained rapidly disappears, to be replaced by a distinct apprehension that we are penetrating a thoroughly obtuse subject as remote from our everyday concerns as sub-atomic physics.

The subject has been hotly debated in the Anglo-Saxon world at least and, as is so often the case, the bitter public controversy between the various protagonists has hardly made the matter any clearer. An initial skirmish with the subject is generally sufficient to conclude that the whole thing is luckily of no direct concern to us and best left for academics to fight out amongst themselves with their habitual relish and bile. Unfortunately quite the opposite is true, for what they are all squabbling about is simply money, and money, whether we like the stuff or pretend not to, concerns us all.

Why economic agents, as the professionals are prone to calling us, or human beings as we are more commonly known, should squabble about money barely needs explaining: some are born greedier than others. Why economists should do so is less self-evident.

At the risk of oversimplifying matters, original sin in the eyes of the monetarists is the creation by governments (and even, in certain circumstances, by banks) of money which, if it does not finance some productive process or activity, simply causes inflation.

It seems to come as a surprise to many people to learn that money can in fact be created. But that of course is what banks are doing if they lend out more of it than people have deposited with them. There is nothing inherently wrong in this; quite the contrary: as long as those who have borrowed can and do pay interest on their loans and repay the loans themselves the whole process is utterly normal, goes on all the time and constitutes a central part of the capitalist system, that part which works on credit.

However, a certain aberration can and does occur. This is the case when central banks or governments pursue ill-timed policies of easy credit and banks lend to borrowers who do not use their loans productively but rather count on a rise in the price of assets, whether property or shares, in order to be able to repay the loan. When this happens, both the borrowers and the banks are confusing the inflation of asset values with the ability of those assets to earn a return. In boom times this happy confusion can continue for some time, leading to the creation of dangerous pyramids of debt. The process even affects economists, one of whom remarked that houses during the 80s "earned" more than their occupants. How a house, even one of ill-repute, can "earn" more than its occupants is not clear. But the position is eventually resolved when the market breaks and everything comes down to earth with a bump, including the overheated imagination of economists.

Governments create money in rather the same way by having to borrow when they spend more than they receive in taxes in order to make up the difference. In this case, the money is created for them by financial markets. (If the worst comes to the worst and the markets balk at providing any more, governments can simply print the stuff, behaving like legalized counterfeiters though with a rather more devastating effect.) In so far as sinning goes, this type of money creation by governments is rather worse than the bank type described above.

When such situations unwind, a borrower's pyramid of debt can collapse with a suddenness that sometimes seems to take the participants unawares. The borrowers, unable to pay back their loans, are left looking guilty and the lenders, obliged to write them off, are left looking foolish. High finance takes on a very low look. This necessary market adjustment, currently being enacted in the US and the UK, is technically termed debt deflation and is more vividly known as a credit crunch. The spectacle of former high flyers (or more accurately high borrowers) coming back down to earth may provide amusement for those who do not suffer its consequences, in much the same way as it can be amusing to see a yuppie, too busy dealing on his car-phone, run into the back of a bus. But the adjustment can go too far. This happens when banks, besides feeling foolish, become worried by the declining value of the collateral backing of their loans and contract their normal lending. The instinctive frightening reaction of tightening the fist can strangle legitimate business and with it the entire economy. Debt deflation can and has led to depression.

Banks, in creating speculative money, make it possible for the recipients to live beyond their means. However, in lending to governments that have to borrow, banks are creating money for organizations that are already doing so. The question of whether governments should borrow, albeit from necessity, is a political one. The consequences, however, are economic – or more precisely monetary: more money is created or, in more monetarist terms, the money supply increases. But whereas inflationary bank-created money tends to be channelled into a fairly narrow field such as property, government-created money is spread very much wider. If a government is in the business of buying votes, universal suffrage requires bribery if not on a universal scale at least on a sufficiently wide one to attempt to ensure re-election.

Economists may argue about whether money created in this way is productive or not, but if, for instance, a government is raising money to pay its employees higher wages to do even less work, the inflationary nature of such money cannot be questioned. Further borrowing may then be required to maintain the loyalty of those who have put the government in power. A process is set in train that is very difficult to stop. The habit of borrowing, like any other habit or addiction, is not an easy one to kick, witness the fact that the UK government was the only one in Europe to have done so over the last decade. Sterling was the only currency in Europe not to have been inflated by its government in this way in the 80s.

While the process is happening the man in the street (or more precisely in the shops) no more notices what is going on than if his neighbour were overdrawing at the bank. Later on, though, he notices that prices are beginning to rise. He reflects that he can afford less and naturally thinks of ways of obtaining more money in order to maintain the way of life to which he is accustomed. Economists refer to this as a wage-price spiral, and current events in Germany are a good example of the phenomenon at work. It seems more easily explicable the other way round, but it is one of the paradoxes of monetary phenomena that an effect is sometimes mistaken for a cause.

Further down the slippery slope, the increase in the quantity of money simply obeys that reassuringly simple law of economics, the law of supply and demand: the more abundant it becomes, the further it falls in value. As Keynes put it, "this progressive deterioration in the value of money through history is not accident and one of its great driving forces is the impecuniosity of governments". In passing, the driving force of inflation in the UK in the late 80s was not the government's impecuniosity (on the contrary, it paid back a considerable amount of debt), but an almost unprecedented orgy of bank lending.

It is curious how often in the history of monetary matters those responsible for some critical or unstable situation are unable or unwilling to admit it. When Ricardo, one of the UK's first monetarists, wrote his great tract "The High Price of Bullion, or A Proof of the Depreciation of Bank Notes", the Bank of England, the target of the tract and source of the notes, stubbornly refused to admit that it was responsible. (One person who did take notice, as a major shareholder in the Bank of France was Napoleon Bonaparte, who had the article published in France. But he of course misused money and destroyed his credit in quite a different way.) In more recent times, it is rather more startling to read in the memoirs of former ministers how unconcerned some of their colleagues were, after a lively bout of money creation, when the IMF bailiffs actually came knocking at the door.

Before paper currencies were introduced the only way to increase the amount of money in circulation without a corresponding increase in the quantity of gold or silver was to reduce the amount of precious metal used per coin. In a world of paper-based currencies, governments that can no longer borrow money can simply print it instead. This is generally thought of as being a decadent Latin American habit which, though true, is also unfair. Many other governments have gone down the same road.

The Germans have done it. The Soviets have done it: unusually, and apparently in accordance with Marxist theories of doing away with money altogether, they also seem to have done it deliberately. One Commissar described the presses of the state mint as "that machine gun of the Commissariat of Finance pouring fire into the arse of the bourgeois system"[1]. But although the bourgeois system survived the treatment and has even been recently reinstated, the printing presses are firing away again in Russia today – though presumably in a different direction.

The French have done it, though with less élan than others. To avoid confusion, above a certain sum French people have to specify whether they are talking about "new" or "old" francs, which were rebased by a factor of 100 more than thirty years ago.

Two countries which have never done it are the US and the UK, perhaps because they have been fortunate in the degree of political stability they have enjoyed as much as anything else. Nevertheless, it is true to say that the dollar, sterling and the Swiss franc are the only major currencies never to have been totally debauched or destroyed by the governments.

It is sometimes true of human affairs that the best way of making a mess of things is by trying to manage them rather than letting well alone. The same is variously true of currencies: it is certainly true of commodity currencies such as gold or silver, but is not quite so clear-cut with paper currencies, which can be either managed or automatically regulated. Readers apprehensive that we may be entering one of the more arcane labyrinths of monetary theory and that the distinction between the two types of currency is a little obscure, may take reassurance from the fact that it does not seem to have been any clearer to one recent chancellor, perhaps because he threw so much of it about in the foreign exchange markets in an attempt to manage the pound[2]. Indeed, the great majority of the UK public neither knows nor cares that for the last seventy years we have lived with what is termed a managed currency, misleadingly perhaps given that it has so declined in value over those years that it retains only a tiny fraction of its former worth.

In the 1920s, when as now there was much debate and discussion about floating exchange rates, managed currencies, the Gold Standard and so on, J.M. Keynes, a rightly acknowledged expert in these matters, argued forcefully for a managed currency

1. P. Johnson, *A History of the Modern World*, p. 93, Weidenfeld & Nicholson, 1983.
2. In 1988-89 UK reserves did a Duke of York, first going up by $10 billion 'attacking' the pound and then falling by the same amount 'defending' it.

or, as one of his acolytes put it, "a little management". In one of his attacks against the conventional wisdom of the day, that the UK should return to the Gold Standard, Keynes recounts how, because of his unconventional stance on the subject, he was inundated with books, pamphlets and articles from all over the world, sent in by people who were considered as cranks and heretics at the time but who regarded him as a sympathetic spirit.

The boot is now very much on the other foot. It is those who hark back to the Gold Standard that are regarded as harmless visionaries, as likely as not believing that markets are influenced by the movement of moons around the planet Jupiter or firestorms on the sun. And although the Gold Standard has recently been invoked by eminent people as a standard of reference, and has been compared to the Deutschemark (in terms rather too flattering for the latter, it should be added), it has had a thoroughly bad press, not least from economists. Perhaps this is merely because the Gold Standard, being an automatically regulated system, would deprive them of the opportunity to advise politicians on how to manage a currency. The flowering of the profession seems to have coincided with the appearance of financial problems such as deficits, from the physiocrats in 18th century France, when "le deficit" was a running sore that the ancient regime lacked the political will to stop, to the same problem in the US today[3].

Not surprisingly, the person responsible for undermining the reputation of the Gold Standard more than anyone else was J.M. Keynes himself, though he did, however, know what he was talking about. Among many other uncomplimentary remarks, Keynes described the Gold Standard as "barbaric" and the insult has stuck. He even invoked Freud to give gold bad name since Freud, newly fashionable, had apparently discovered amongst other unhealthy things lurking in the subconscious "peculiar reasons why gold in particular should satisfy strong instincts and serve as a symbol"[4]. It would perhaps be fairer to say that most people harbour in their subconscious nothing more peculiar than a strong desire for security in an uncertain world. Only in very rare cases of avarice does this become a fixation with gold or any other precious metal.

It is such a long time since the Gold Standard was abandoned, or more precisely since the beginning of the process whereby it was undermined (1914), that accurate notions of what it really was are hard to come by. There is still a trace of it left over on the bank notes we handle all the time, the "promise to pay the bearer". (The Americans have had the tact to remove this promise from their dollar bills and have left their bearers to trust in God – a risky move as He has made it known that He should not be held to account in such matters.) What this promise meant was quite clear and unambiguous: armed with a pound note, a person could go into a bank and demand the equivalent in gold if for some reason he mistrusted the piece of paper and preferred the safety of holding a piece of metal. Commentators often seem rather surprised that there was little apparent debate about "monetary policy" in the 19th century. In fact before a stable system was

3. There is perhaps a correlation between record US deficits and the number of US Nobel prizewinners in economics that economists themselves have failed to notice.
4. *Auri Sacra Fames*, J.M. Keynes, 1930, Collected Writings Vol. IX.

created there was a great deal of lengthy and obscure debate, much as now, but as an essential part of the system was simply written on bank notes there was little more to be said other than the currency was "backed" by gold. In passing, one of the ways in which the Gold Standard was insidiously undermined was through the measure imposed by the authorities whereby they would no longer deal in £1 sovereigns but only in bullion, which effectively deprived private citizens of the right to manifest, or more accurately to materialize, their mistrust. (Another factor was the law passed at the same time forbidding the export of gold, a measure whose effect was only really annulled with the lifting of exchange controls in 1979.)

However, the promise to pay the bearer was not the whole system. If too many bearers hurried to the banks with the same pressing demand, a crisis developed. There were three really serious financial crises in the UK in the 19th century under the Gold Standard, properly established by the Bank Charter Act of 1844. In one of them, the Bank of England lost half its reserves of gold. The business of banks burying gold in their vaults often irked Keynes, who regarded it as a somewhat useless activity, but this uselessness is comparable to that of a fire extinguisher forgotten under the staircase until fire breaks out and panic sets in.

But things were not as simple as one might imagine. The Bank could not just dole out gold like soup from a soup kitchen. The actual procedures illustrate the two aspects that were most fundamental and central to the working of the system: the law and the limit set by the law. In accordance with the basic principle set out by Ricardo some time before, that a paper currency should act like a commodity or metallic currency, the amount of paper issued was limited and the limit was laid down by law. If, in a panic, gold was drained from the banks and there was insufficient gold backing the currency, the law had to be suspended by an order in council. Where this limitation (the corner stone of the system) is not laid down by law, currency systems are doomed to failure whether they are backed by gold, such as the Russian chernovetz in the 20s, or by confiscated land such as the French assignat. The Bank of England was required by law to control what we would now term the monetary base and did it successfully for eighty years. Contemporary economists who maintain that it is impossible to do this are flying in the face of eighty years of history. A modern version of the system known as monetary base control, devised by Professor Gordon Petter[5], does not include this legal security but the temptation for governments to manipulate the monetary base is so strong that probably nothing but the law will stop them.

These two essential elements of the Gold Standard were completed by a third which ensured that the system functioned smoothly. If the Bank had to control the amount of currency in issue to keep the system stable, no source of inflationary money could be countenanced. The government throughout this period refrained from creating money – it did not commit that original sin. Any central bank, however "independent", is vulnerable to a government which borrows and creates money, the Bundesbank being no exception.

5. *Restoring credibility: Monetary Policy Now.* Gordon Pepper, IEA, 1992.

It was in this way that the whole structure of money and credit was built up on a stable base maintained by law. On no account could it be described as a form of "pyramiding", at least in the sense described above, which is one of the more absurd things that has been said recently about the Gold Standard.

After lengthy controversy and a certain amount of trial and error (and financial crises), the Victorians built up a system which maintained a non-inflationary currency: some prices inflated (and deflated) but the currency did not. Their values and standards have been much derided over the past decades. However, were they able to observe the treatment to which modern governments have subjected inflation – gently curbing it, then squeezing it, then fighting it even more violently until it has been stamped on, crushed, annihilated and, we are asked to believe, finally licked-it would surely be their turn to laugh. Perhaps even Keynes might have found such efforts to manage currencies somewhat barbaric.

In the ambitious project of European monetary union, a glimmer of some of the aspects of an inherently stable system such as the Gold Standard emerges from the myriad discussions. Limits are being set on "excessive" government borrowing, though a purist would of course maintain that there should be no borrowing at all. The manipulation of interest rates for electoral purposes is gradually being prised away from governments' grasp. But what worries monetarists is that the present exchange rate mechanism, the chosen route towards monetary union, creates significant distortion. Moreover, its central and mainstay currency, the Deutschemark, is likely to go through a period of considerable turbulence following a decade of government money creation modest by other standards, the sort that Keynes said nobody noticed, but which has been compounded by a rather sharper burst of recent activity. (It has unfortunately been forgotten by some that a similar system was destroyed by that great creator of inflationary money in modern times, the US Treasury. Unlike the arrival of the US Cavalry, its appearance in financial markets followed by a wagon train of debt is greeted more with dismay than relief.) Both of these factors could beach the project before it has a chance of succeeding. However, as it took the UK several decades to find its way towards the system it so successfully developed, it would be no surprise if Europe also took as long.

Monetarists worry about monetary systems whereas politicians worry about power and raise the vexed but far from outdated problem of sovereignty. Under the Gold Standard things were clear: the government surrendered its power to debase or manage the currency to a bank which had its hands tied behind its back by law and whose only remaining function was to maintain sound conditions of credit. Governments which try to manage the currency find themselves managing not only that but the economy as well, and usually end up mismanaging both. But before surrendering this power it is quite natural that they should feel fully confident that the institution to which they are handing it over merits their confidence and above all that of its citizens. As the institution in question does not even exist, it is quite right that the UK and other governments should have kept their options open.

PRIVATIZING PUBLIC ENTERPRISES

By Cosmo Graham and Tony Prosser, Clarendon Press 1991

Subtitled "Constitutions, the State, and Regulation in Comparative Perspective" this thorough and utterly academic 260 page analysis serves well a number of separate purposes:

i) To provide an account of methods and events surrounding the privatisation of industries in Britain in comparison with other countries – though mainly with France.
ii) To inform the reader of those aspects of law which are relevant to this process.
iii) To make the political point that "one must take constitutions seriously, an argument which would not seem radical in either France or the United States".

Perhaps for the majority of us, privatisation has been an economic or an ideological issue. We turn our thoughts to questions of efficiency, of monopolistic pricing, of private ownership or common ownership, and of economic growth. Some of us see nationalised industries as fossilized dinosaurs stunting the nation's progress whilst others despair of private enterprise. In contrast to these provocative preconceptions, it is a rare pleasure to approach the issues from the dry perspective of the constitutional lawyer.

Graham and Prosser draw on a rich comparative literature. They show how privatisation has progressed in markedly different ways in France – a country well able to demonstrate the more 'continental' approach. They show how the regulatory bodies now set up to implement the government's responsibilities to protect the public interest against the once nationalised industries, need to learn much from experience in the US where a constitutional framework has evolved on this issue. Perhaps most pertinent, even alarming, of all, is the conclusion that Britain is increasingly subject to EC laws and regulations thus imposing, by proxy, continental constitutional limitations on U.K. privatised industries.

Few have yet realised that Britain, a country so complacently arrogant of its constitutional arrangements, is in fact being drawn towards a precipice as events, irresponsible comment and ill luck undermine respect for every institution in sight – from Parliament to the Monarchy, from the police to the courts – and much else. History's intention, for good or ill, is best served however by loudly proclaiming the need for public debate and academic study of British constitutional issues. Comparative perspectives allow us to defend our heritage and adapt where others have done better. In looking at the government's relationships with privatised industries we all have much to gain from this instructive and thought-provoking text.

J.B.

THE EDWARD HOLLOWAY COLLECTION REVIEW

Pillars of Cloud by John Scanlon
Published by Chapman and Hall 1936

This book reviews the words and deeds of politicians in Britain – and elsewhere – between 1918 and 1936. The conclusion reads:

"After 18 years of their rule they are now with once voice telling us that never was the situation in Europe so dangerous. And in America there is a play running called "Bury the Dead," by a young man called Irwin Shaw. It shows how some of the lads who were killed in the last war had refused to be buried. They would not admit they were dead. They had not a chance, one of the lads says:-

> ' ... I was only twenty, mom. I hadn't done anything. I hadn't seen anything. I hadn't even had a girl. I spent twenty years practising to be a man, and then they killed me ... I waited, mom but then I got cheated. They made a speech and played a trumpet and dressed me in uniform, and then they killed me ...'

Eighteen years from now other lads, too, may be protesting that they had never lived. That is the price we pay for trusting our lives to men who know nothing of what is wrong with this world – men who believe we are still in the famine period instead of the era of plenty. Pre-War minds rule the world practically everywhere. Chemists, scientists, and engineers have again demonstrated at Blackpool this year that their part of the job is complete. There is plenty for all. The reply of British statesmen is to tighten up the Means Test. Fascism may come to Britain, but it will not come because of the strength of the Fascists. It will come as it came in Italy and Germany where men wanted to argue futile politics, instead of organising production to meet consumption.

Some day, however, we may recognise that the capacity to act and talk well is not the sole requisite for a statesman. In 20 years of rule they have produced wars, threats of wars, and poverty everywhere. The chemist, the scientist, the engineer, the men of knowledge must take the job out of their hands."

So now, read the book. In the main it is a familiar enough account of the inconsistencies, contradictions and ineptitudes surrounding such topics as war loan interest payments, cuts in government expenditure, rising unemployment and poverty amidst plenty during the depression years. It chronicles a bewildering maze of speeches, actions and confusions. And does so with irony, sarcasm and wit. Chapter 19, for example, discusses agricultural policies in a way which will make any honest pro-European blush for thought of the CAP. Hops, potatoes, pigs and much else was subject to quota restrictions on output – and windfall profits were guaranteed to farmers for *not* producing, but selling their quota rights.

But to be topical we can turn to page 264 to read:-

> "A national Government was formed to keep Britain on the gold standard. Everybody prophesied doom and woe to Britain if ever we departed from gold.

Mr MacDonald toured Durham with a suit-case of old German paper marks as a terrible example of what would happen to their sovereign if we went off the gold standard. Miners, who had not seen a sovereign since the War, were terribly impressed. MPs, who had been in almost every part of the habitable globe on holiday, hurried back to prop up the £1, and when it was found that it could be done by cutting unemployment benefit and civil servants' and teachers' salaries, they felt the sacrifice had not been in vain.

And whilst they were still stressing the dire consequences of going off the gold standard, they got too near the edge and just quietly slipped off. Nobody was any the worse or better. It had just precisely the same bearing on the problems of production and poverty as the tax on fabric gloves, and the politicians had got equally excited about both."

And so we can return to the politicians, to Mr Baldwin who "still remains a simple honest man.", to Mr MacDonald who "still struts across the stage, a pillar of cloud both by day and night", to Mr Lloyd George, "most bellicose of all the followers of the Prince of Peace, still the greatest actor of the lot", and Mr Churchill who "is still here, cajoling and biting by turn, his arithmetic as good as ever".

But, says John Scanlon, "of what they said or what they did, nothing remains of permanent value".

Nothing, mom.

J.B.

JAPANESE INVESTMENT IN THE U.K.

An unpublished letter to The Times from the Hon Secretary, recently in Japan.

Dear Sir,

Having spent 3 of the last 10 years lecturing on International Trade and Investment in Japan I would be grateful if you would allow me to comment on the claims being made that Japanese investment in the UK would be put at risk if Britain fails to ratify the Maastrict Treaty.

The Japanese tend to avoid involvement in other nations' political debates and it is only too easy for interested parties to claim their support knowing that Japanese refutation or opposition will remain largely silent. Hence the present dilemma and problem.

The facts are that during the 20 years of UK EC membership the UK share of Europe's Japanese investment has actually dropped from over 60% to around 45%. More central locations and certain subsidies (particularly in Holland) probably account for the drop. But the 45% still represents an important commitment to Britain.

Studies made by Japanese consultants have consistently concluded that foreign investment by Japanese firms follow logical commercial criteria rather than the politics for the day. The principal reason for locating in Britain has been the fact that Britain has for a long time been more open to Japanese imports. Once a market for sufficient sales has been established, local manufacture can follow. To this must be added the language factor, past relationships between Japanese and British companies, the welcome the Japanese have received there (and the golf courses!), Britain's relatively low wage rates and availability of skilled manpower and – a factor which is all too often ignored – the fact that goods and plans prepared for and first tried out in America can be used in Britain without much alteration or translation delay. Having sorted things out in America, the Japanese can get on with the job in Britain.

The effects of "Euro-politics" are really secondary. Certainly the threat of "Fortress Europe" (which EC representatives in Tokyo do little or nothing to refute) has led to a speeding up of investment decisions thus distorting international trade and investment patterns. It is hard to know whether this is a cause for pride or shame but at least the "single market 1992" process, which is quite independent of the Maastrict Treaty, may bring about the promised market scale – in time.

But EC protectionism is at least in part to blame for the current loss of direction and possible depression in the Japanese economy – which could, in theory, lead to distress closure of Japanese plants overseas. More important however, has been the effects of Britain's ERM membership which came fearfully close to pricing British made Japanese products out of EC markets. Britain's exit from the ERM has been greeted with quiet relief.

Ratification of the Maastrict Treaty would present the Japanese with quite unpredictable political consequences. Why, they ask, do you want to rock that boat? And why sign a treaty that commits you to rejoining the ERM? If the Japanese have any view on the matter, they probably wish that the Maastrict treaty would go away!

Yours faithfully,

James Bourlet

THE ECONOMIC RESEARCH COUNCIL

Honorary Secretary's Report and List of Members 1991-92

MEMBERS

During the year under review 16 new members were elected, of whom 9 were Ordinary Members, 6 were Honorary Members and 1 a Corporate Member.

MEETINGS

Seven dinner meetings were held during the year, as detailed below:

April 15th 1991	Dr John Eatwell, Economic Advisor to the Rt. Hon Neil Kinnock, who spoke on "Current Monetary and Industrial Policy".
May 28th 1991	Professor Kenneth Minogue, Professor of Political Science at the London School of Economics, who spoke on "Economics and the Moral Life"
September 12th 1991	Professor Geoffrey Wood, Professor of Economics at the City University Business School, who spoke on "United States Monetary Policy"
October 30th 1991	Mr Tetsuo Yagi, Deputy Chief Representative at the Bank of Japan, who spoke on "Monetary Policy and Practice in Japan"
November 28th 1991	Mr Anthony Werner, Chairman of Shepheard Walwyn publishers, who spoke on "The Economics of Publishing"
January 28th 1992	Mr Fred Harrison, Journalist and Writer, who spoke on "Land and Money"
March 16th 1992	Mr David Kemball-Cook, Economist at the London Business School, who spoke on "Green Economics"

The dinner meetings were held at the St. Ermin's Hotel, Caxton Street, London S.W.1. On all occasions Mr Damon de Laszlo took the chair. The meetings were generally well attended and were followed by lively discussions.

EXECUTIVE COMMITTEE

The Executive Committee met four times during the year, immediately before the dinner meetings, and at the Annual General Meeting.

ENGLISH SPEAKING UNION AND ERC

At the suggestion of the President, Lord Ezra, discussions were held with the ESU with a view to the ESU providing administrative services and meeting facilities for the ERC. The ERC would enter some form of association with the ESU. When it seemed that this might mean the ERC losing its separate identity, the question was put to members, who

voted by post strongly in favour of the ERC remaining independent. Discussions were resumed with the ESU for a different form of association but foundered on cost.

SECRETARIAL DUTIES

The duties of Honorary Secretary were shared by Messrs Bourlet and Cadman during the year under review.

The Honorary Secretaries take this opportunity to record their thanks to Mrs C.R. Wood who, courteously and competently did the day-to-day work of running the Council.

PUBLICATIONS

"Britain and Overseas"

The quarterly journal of the Council was published regularly through the year and received favourable comment. The Editor (Mr Bourlet) takes this opportunity to thank those members who submitted items for publication.

FINANCE

The annual accounts were prepared by Mr C.N. Malacrida of Chantrey Vellacott.

Membership List December 1992

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Combined Heat & Power Association
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Electronic Engineering Association

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	£25 per year
Corporate members	£55 per year (for which they may send up to six nominees to meetings, and receive six copies of publications).
Associate members	£15 per year (Associate members do not receive Occasional Papers or the journal 'Britain and Overseas').
Student members	£10 per year
Educational Institutions	£40 per year (For which they may send up to six nominees to meetings and receive six copies of publications).

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.

APPLICATION FORM

To the Honorary Secretary
Economic Research Council
239 Shaftesbury Avenue
LONDON WC2H 8PJ.

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	Individual membership (£25 per year)
(delete those non-applicable)	Corporate membership (£55 per year)
	Associate membership (£15 per year)
	Student membership (£10 per year)
	Educational Institutions (£40 per year)

NAME ....

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

NAME OF ORGANISATION ....

(if corporate)

ADDRESS ....

....

....

PROFESSION OR BUSINESS ....

REMITTANCE HEREWITH ....

SIGNATURE OF APPLICANT ....

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

AND SIGNATURE OF PROPOSER ....