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AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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THE EUROPEAN UNION

Extracts from a talk by Ray Whitney, O.B.E., M.P., Chairman of the Parliamentary Positive European Group, to members of the Economic Research Council on Thursday 26th September 1996.

Whilst I venture to suggest that the "vision" of Economic and Monetary Union (EMU) is primarily economic, it is of course heavily salted with politics. As I am proclaimed to have a more genuine locus to offer views on politics than economics, let me start off on the political side of that equation before I get into the trickier waters of economics.

We, the Brits, have always had difficulty with the Continent for all sorts of reasons that all of us here will understand. My generation does have a lot of baggage – the war and all the rest of it, but it goes deeper than that. It involves that strip of water and that Empire and all the extraordinary history that this group of islands off the north west coast of Europe have managed to achieve over so many centuries. This has left a very deep imprint and, although I don't agree with all that he says, I admire the way Paul Johnson in his book "The Offshore Islanders" demonstrated that every time we put our foot across that channel and dip our fingers in (or whatever the metaphor is) we get into trouble, but if we pick up our skirts and keep out of it and look elsewhere, all is well.

I think, however, that the world has changed. The Empire has (almost) gone, the Commonwealth means little and our special relationship with America is not what it was. Striking a personal note, between 1960 and 1963 I was loaned to the Australian Government and had the advantage of an "inside" view. At that time the Australians were pulling all the strings saying "remember Gallipoli" and "we died for you in the Dardanelles". But time moves on and even in the 1960s they were saying "actually we are an Asian nation and what happens in America and Japan is of more importance to us that what happens in Britain, France or Germany".

Post War Developments

We must look at what has happened in Europe since the war. At the Messina Conference (to establish the European Coal and Steel Community) the main countries of Europe sent their Ministers but we just sent an official from the Board of Trade who came back and said "We don't want any of that lot". That was 1951 and in 1956 they signed the Treaty of Rome – and we did not.

Then they erected awful things like the Common Agricultural Policy which we are still living with – and hope to get right one of these days. We tried something called the "European Free Trade Area" with what was left of the countries of Western Europe but then changed our minds, knocked on the door and said "Please can we come and play your game?". De Gaulle said "Non" and it took us 11 or 12 years before we got there in 1973 – by which time the rules of the club had been set in a way in which it is certainly reasonable to believe they would not have been set had we been at the table. We've lived with that ever since and never really caught up. To start with the Labour Government in 1974 tried to re-negotiate the CAP but didn't get very far. Then, to satisfy divisions within the Labour Party, we had the 1975 Referendum which, by a majority of two to one* said "We'll stay in Europe".

A lot of people now say "We thought we just joined a free trade area – we didn't know there was anything else". But I could quote you endless speeches by Margaret Thatcher or Edward Heath or Roy Jenkins or indeed by many of the opponents of membership, in which it was made clear that it wasn't just a free trade area.

I can tell you, as a "working diplomat", that people in other parts of the world do have a habit of thinking that the West Europeans *more or less* have a point of view. Of course, there will always be examples of differences between us – such as in Jugoslavia or on whether the Americans should have bombed Gadafi and Libya or what to do about Sadam Hussein. But there is a broad mass of approach which obviously has deep roots in our culture, in our civilisation, and one may wax emotional about Beethoven, Mozart, Shakespeare and whatever. In my view there *is* something that is distinctively West European which is like the elephant, (you can't actually describe it, but you recognise it when you see it) so that decisions taken in any European capital are recognised by the rest of the world as being "European".

A Will for Unity and National Identity

In my view there is a deep will amongst the Continental nations of Europe to get together and to stay together and to get the damn thing to work, without losing fundamental National identities. Although we have bilateral meetings with the French, the German, the Italians or whoever, in which we make rude remarks about the French (to the Germans) or the French make rude remarks about the Germans (to us), it is really like a family, like cousins and nephews having sharp things to say about each other. But not enough people in Britain understand that whilst the French complain about the "Franc fort" and unemployment, the Germans about slow growth, the Italians and Belgians about public debt etc., these are problems yes, but problems which they are bloody well going to solve – and solve without the French ceasing to be French or the Italians Italian. Each country has a different relationship with the European Union but none (or very few) of them think their fundamental National identity is under challenge. They argue about institutions and mechanisms but it is we who manifest a loss of National self-confidence and imagine that those wily Continentals will out-flank us.

The Maastrecht Success

Somebody is going to say 'Ah, but we the British obey all the rules and none of the Continentals do'. I cannot deny the point and it is a fact we have to live with. But this

* Of the total electorate some 25% did not vote, 26% voted against and 49% in favour.

is one of the reasons why we strengthened the powers of the European Court in the Maastricht Treaty and now we are complaining that the European Court is too powerful! You can't have it both ways when all the Continentals are saying that those damned British have out-flanked them.

In the Continental European Press, Maastricht was played as a huge success for John Major through his opt outs and so on. "Major hoodwinks", "Major pulls the rug from under", "Major gets away with it", they said. In Britain, the poor chap didn't score a point at all and I felt, as you might imagine, that this was very unfair.

The Damaging Influence of Two Anti-European Colonialists

The whole picture has been made very much more complicated by the impact of two people – two Colonials. Mr Rupert Murdoch who started life as an Australian and found it commercially convenient to take out United States citizenship, and Mr Conrad Black, a Canadian. I know Murdoch a bit. I don't know Black at all. None of the people whom I know who know them quite well can quite understand when, but somehow or other at some point they took "agin" Britain having a constructive relationship with our Continental European partners and, as they own some 40% of the media, have been able to appoint editors and feature writers and so on who have this point of view. So you have this extraordinary blitz against Europe which has created huge damage for the country and for my Party (The Conservative Party). The whole time Mr Bill Cash or Sir Teddy Taylor rabbits on playing gunmen on the 8.15 slot on the Today Programme, is an absolute dream for the media men because it torpedoes the Conservative Party, day, by day, by day. It is this background which colours the whole debate in which we must try to think about the proposed European currency.

Playing the Federal System

The term 'Federal Europe' is thrown around and around. To the Germans of course, Federal means something very loose. Their *Lander* have considerable powers, can sign cultural treaties and so on and can think of themselves as unitary states. I am sure that there are some people in the Brussels Commission who think it would be lovely to be the Permanent Secretary for the whole of Europe but the real thrust for that is fairly limited. Just what the future institutional relationships are to be, I do not know. One policy will go this way, another that way and the foreign and security policies will go yet another way. Whether or not qualified majority voting in some sectors will be increased I simply do not know. But I absolutely do know that no Frenchman would ever sign up to anything that lost the basic national identity of France. *They* know that they can play the system and I am confident that *we* can also play the system, in fact that we *do* actually play the system even if very few of us here know this.

A Non-Economist's Assessment of the EMU

I am not a professional economist but I suggest that the "dreaded" EMU probably makes quite a lot of sense. It seems to me perfectly straightforward to say that if you want to have a single market then why not have a single currency?

One of the things that has threatened all of us, particularly Britain, is that we have all been so vulnerable to currency speculators – the "George Soros" phenomenon. Stability is what all economies need – especially an economy like the British economy which is so dependent on international trade. The whole question of foreign exchange levels and interest rates is of crucial importance to us and, over the years, we have tried various ways of managing this. Before the First World War we used gold, then there were the ins and outs on the Gold Standard in 1926. Later, the Bretton Woods agreement fixed the pound at 4 dollars, later devalued to 2.8 dollars and then in 1967 to 2.4 dollars. Between 1965 and 1994 the pound fell from DM11.20 to 2.30. So it all went wrong and there has been tremendous pressure on the British economy and on interest rates and all that that means.

There are risks and negative factors of course, but think of the benefits of having a stable, solid "Euro" which would not be vulnerable to speculators and which would be a world currency with the strength that everyone credits to the DM. I think I am right in saying that over recent years interest rates in Britain have been something like 1½ to 2% higher than in Germany because people lack faith in the pound. Interest rates in this country are still very high by Continental standards and indeed by historical standards and that has had an impact in itself on investment and our economic prosperity. I believe that there is a strong case for saying that EMU would give us lower interest rates, a wider market and lower inflation due to greater competition together with a much better chance of development and economic growth. And we can look at the American example with their huge market. If 6,7 or 8 countries in Europe can provide such a huge and affluent market it must surely lead to greater growth.

The benefits in terms of transactions costs are even more obvious. There is the old joke that if you take £l00 from Dover and travel around the Capitals changing your money you come back with £51 or whatever. Some estimates put the annual benefit at something in the order of £2½m to £3m to the British National Economy. It is said that there may be some losses in the City of London because people aren't doing all this changing, but a lot of the trading in the City is by foreign firms so I think that the loss would be fairly limited. The overall impetus will be very positive and strong and be a big impulse to growth.

The Maastricht Criteria

Now, what about the famous question of the Criteria, you know 'the debt musn't be more that 6% of GDP', 'inflation must be under 3.2%', 'the exchange rate must be stable' etc. All these criteria mapped out in the Maastricht Treaty seem to me sensible, straightforward and simply good housekeeping for any Conservative.

Of course, if you say “No. We want a bit more spending and a little inflation doesn’t do anybody any harm” (a fairly terrible point of view – not one that I hold), I could understand you taking the opposite view. But I find it odd that those on the “dry right” of my Party such as my colleague John Redwood (who you would think would applaud these criteria) say “No. no, they’re wicked and horrid” because (actually he doesn’t say this) because *foreigners* say they are a good idea.

I personally believe the economic case and that it is certainly worth staying in the negotiations – staying positively in, in a way that convinces our partners that there is a genuine chance that we might join. But some suggest that we should stay at the negotiating table to slow it down or muck it up! This seems very odd and a pretty negative way forward. And of course the Europeans are getting more than a little tired of this.

EMU Will Happen Whether the German People Like it or Not

One problem is the attitude of the German people. Having gone through the Wehmar Republic and all the horrors that are still deep in their national consciousness, they are deeply proud and deeply jealous of the solidity and stability of the DM. At the moment there is a current of opinion going against EMU there. One might well say “Who should blame them?”. Certainly if I were a German I would say “I’m not going to let loose my DM with those feckless British or with the French, who aren’t much better”.

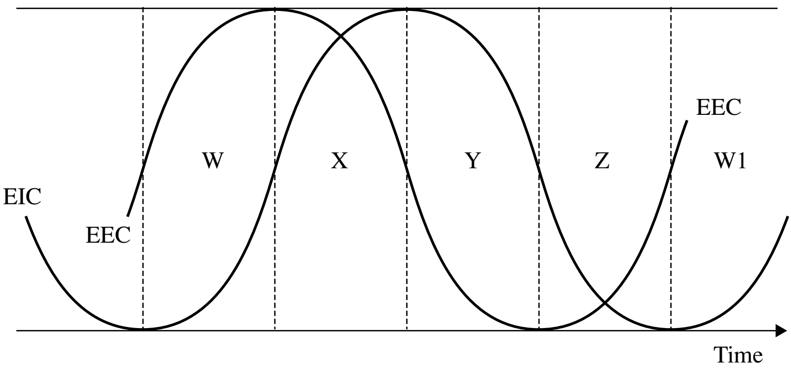
Nonetheless there seem to be some quite intelligent people on the Continent who seem to think it may work. The nearer we get to the starting time, the 1st January 1999, the more it looks probable that it will happen even if some of the criteria aren’t quite met and we have to rely on only the trends being in the right direction. It is time for us in Britain to realise that the single currency will happen and it is right for us to join in.

ASSET ALLOCATION THROUGH A BUSINESS CYCLE

Extracts from a talk by Mr David Shaw, Director of Strategy at Legal and General Investment Management, to members of the Economic Research Council on Tuesday 29th October 1996.

Both at a world and an individual country level there are periods when equities outperform bonds in a major way. And vice versa. And during some periods cash may be preferable to either. Such a perception was the basis of John Maynard Keynes’ successful personal portfolio management in the inter-war years. The reason

Chart I Interaction between Bond & Equity Returns



EIC = market's expected inflation rate cycle

EEC = market's expected corporate earnings cycle

for these contrasts in return performances is, quite simply, the behaviour of the business and inflation cycles. The *anticipation* of changes in these cycles should form the basis for asset allocation.

The WXYZ Analysis

We have developed an analytical model enabling us to make country asset allocation decisions. It is a sequential four time zone analysis of the business and inflation cycles depicting differing combinations of bond and equity market returns within each time zone. Briefly, the analytical model assumes that:

- bond investors anticipate the inflation cycle by 12 months
- equity investors anticipate the corporate earnings cycle by 12 months
- the earnings cycle **leads** the inflation cycle.

Chart I presents the timing interaction between the equity market's earnings expectation cycle and the bond market's inflation expectation cycle.

By partitioning the respective peaks and troughs of these two hypothetical expectational cycles it is possible to delineate four distinct sequential time frames (W, X, Y, Z). The four different pairs of expectations correspond to four potentially different bond/equity relative return performances as follows:-

- In W, earnings expectations are rising, so too are inflation expectations. Equities should outperform bonds. Asset allocation is unambiguous.

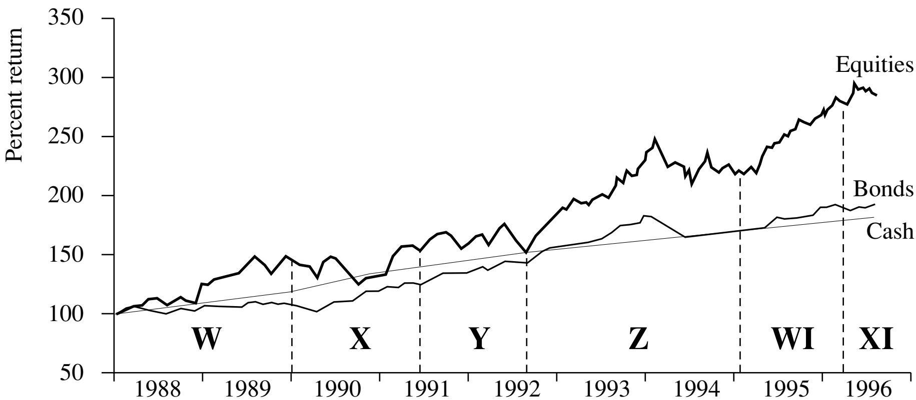
- In X, earnings expectations are now falling and inflation expectations are still rising. Relative performance of bonds and equities is not clear cut. It will depend upon the degree to which investors are continuing to revise upwards their inflation expectations compared with the extent to which they are revising downwards their earnings expectations. Asset allocation is ambiguous. Cash could be preferable since the return on both other assets should be falling.
- In Y, earnings expectations are clearly falling and so too are inflation expectations. Bonds should outperform equities. Asset allocation is unambiguous.
- In Z, earnings expectations are rising and inflation expectations are still falling. Relative performance of bonds and equities is again not clear cut. It will depend upon the degree to which investors are continuing to revise downwards their inflation expectations compared with the extent to which they are revising upwards their earnings expectations. Asset allocation is ambiguous. However, it would be wise to hold little cash since the return on both other asset classes should be rising.

Looking at the UK Experience

The model is fine in theory but if it is to have a relevance to the practical task of tactical asset allocation, is there any empirical support for the existence of these zones of differing bond/equity return performance?

Our analysis concentrates specifically on the relative returns on UK gilts and equities from 1988 to 1996 – see Chart 2.

Chart 2 WXYZ Model in the UK: From Theory to Practice



Zones WI and XI are members' suggestions.

Source: Micropal 23/8/96

The choice of 1988 was dictated by a desire to start the empirical evaluation with a stable bond/equity yield ratio, following the 1987 Crash, of close to 2.175. At the time, this was regarded as the long term 'fair value' between these two asset classes.

Between 1988 and the third quarter of 1989, the total return on UK equities substantially outperformed gilts. The economy was growing strongly and inflationary pressures were rising. We believe this period corresponds to the W zone in Chart I. For the next 15 months the returns on **both** bonds and equities fell – underperforming cash. Zone X predicts just such an outcome and X did indeed follow W as the model also predicts. This is then followed by an even shorter 12 month period in which the total return on equities falls while that on bonds rises. This outcome is unambiguously predicted from a Y zone location.

Reacting to this thesis members then suggested to Mr Shaw that the period from the third quarter of 1992 to the first quarter of 1995 was one on which the return on bonds and equities were close with no clear message except that they both beat cash. This period's performance was what would have been expected from zone Z. During the next 12 months equities outperformed bonds, corresponding to W1 but we currently, perhaps signalled by recent small increases in interest rates both in the UK and the USA, appear to be moving into X2 where earnings expectations are falling, investors are continuing to revise upwards their inflation expectations and cash could be the preferable asset.

In the ensuing discussion members agreed with Mr Shaw that whether or not this precise timing is correct, the model has the great value of indicating the correct *sequence* of events, at least during periods when political economic priorities remain constant. A change from "low inflation" to "full employment" aims or to membership of a single EU currency, for example, might modify the pattern.

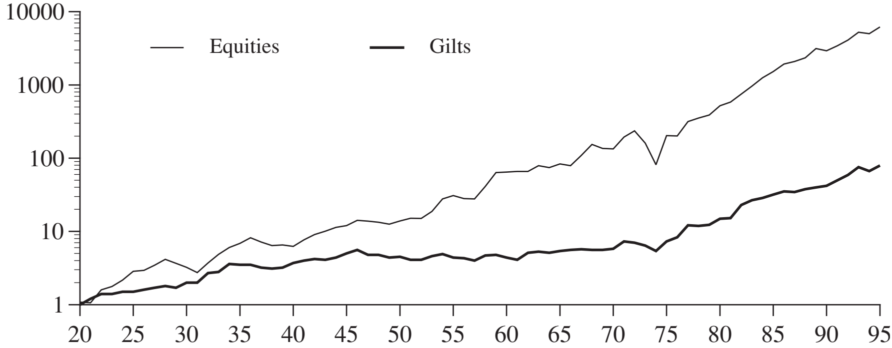
For further discussion of this topic members may request copies of back numbers of "Fundamentals", the newsletter of Legal & General Investments.

UK EQUITIES – THE REAL LONG VIEW

By Christopher Daws

Readers will be familiar with the prosperity that an investment in UK equities has produced for investors. Since the First World War, with just a pause for breath in 1974, their progress has been unstoppable. For a non-taxpayer, £1 invested in 1920 would now be worth £5,742 (a compound total return rate of 12.2% p.a.). In gilts it would have become a mere £79 (6.0% p.a.).

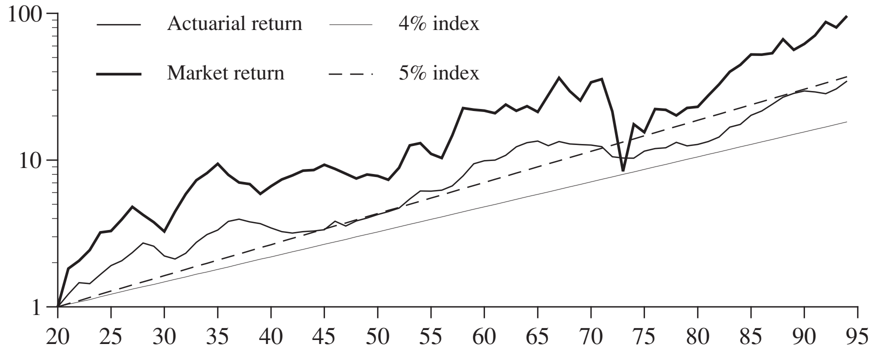
Equities and Gilts Total Return Indexes



Alas, such returns are measured against the fickle standard of the pound Sterling. What should concern all investors is the returns in real terms. Many would treat the RPI as their standard. But for pension funds and endowed charities, average earnings are usually more relevant as the standard. Pension funds have to deliver a pension linked to a member's earnings (even though it may increase in retirement at RPI or less). Charities incur much of their expenditure on people: their funds need to keep pace with the growth in earnings if they wish to deliver a constant volume of expenditure in real terms.

The return on equities in real (earnings deflated) terms is thus of vital significance to investors. The second graph shows this on two bases: market return and actuarial return. The actuarial return substitutes, in place of market values, an actuarial value which simply capitalises the current dividend stream at 4.5%.

Equities Total Return Index less Increase in Earnings from 1920 to 1995



Trend lines of 4.0% and 5.0% p.a. are shown, since the long term return falls between these. Returns over some representative periods were:

	Actuarial value (%p.a.)	Market value (%p.a.)
1981 to 1995	7.01	10.03
1966 to 1980	(0.32)	(0.26)
1950 to 1965	8.19	7.34
1921 to 1995	4.91	6.28
1930 to 1995	4.23	4.64

Returns over the last 15 years (to 1995) have been exceptional. Those in the previous 15 years were negative: the real capacity of an endowed charitable fund invested in equities shrank over that period even if it made no distributions. The 1970s saw pension funds run into large deficits and the 1980s have seen large surpluses (albeit due partly to industrial and commercial downsizing).

The long term cycles apparent from the graph should worry any trustee. Are we at the peaks of not only a market cycle but also of an economic cycle in terms of the rewards to capital at the expense of labour?

After 15 years of feast, is it time for 15 years of famine again?

ENGLAND! THE NATION THAT GAVE ITS FUTURE AWAY

By Ron Read

The English are not an ancient people; a mixture of many races they stabilised into a recognisable culture around the time of the Tudors.

Built on coal, covered in forests, surrounded by fish, oil and gas, with deposits of many useful minerals, a temperate climate, and some of the finest pasture and arable land on the planet, England ranked, assets per capita, among the wealthiest countries in the world.

By the late 16th century a talented, commercially acute, people, forged continually in the furnace of conflict and compromise, had emerged with the beginnings of democratic government. Initially evolved to stabilise the conflicts of the powerful. This eventually became a system in which the population at large elected their rulers.

Led by the English (who had brought stability to those earlier arrivals from the Balkans, the warring Celtic clans), the island races, collectively known as the British, following trade not conquest, built the greatest world-wide empire yet seen: exporting the seeds of democracy in the process.

Having played a major role in the defeat of Napoleon early in the 19th century, giving the beginnings of true democracy to Europe and freedom from major conflict for nearly a century to herself, Britain, her Empire and Commonwealth, in 1914 joined the coalition which, with the belated help of the USA (a nation formed from the ideals of English Democracy and culture), defeated Germany's attempt at European and world domination. I believe 1916 marked a turning point and would note two events. First, the Southern Irish, with the help of their USA lobby, took the opportunity, at a fraught time in the conflict, to rebel against the union with Britain. Secondly a few residential rents, typically in Carlisle, rose, following labour migration to newly prosperous munitions towns. Some locals, unable to pay the level of rent supported by the freak market, were threatened with eviction. In response to a problem, inflated and generalised from a few specific examples, the wartime coalition passed legislation to control existing domestic rents. These Rent Acts were to lie dormant on the statute book between the wars to be re-enforced and produce dire effects to the nation's economy and place in the world when applied, following the Second World War, by those seeking to municipalise housing.

Despite the later successful generalisation of a few atypical examples by a left wing aiming to prove to the contrary, the twenty years between the world wars were ones of previously unknown prosperity and social progress. In proof of that statement, over five million new housing units, around half for rent, a figure not exceeded in the next forty years, were built, mainly with private capital. Owner occupation spread and with the consumer boom that followed, many new modern industries, typically aircraft, cars, electrical goods, and furnishings, were created, as were a million new jobs.

In 1939 Britain, her Empire and Commonwealth, were again forced into a war with Germany and the great, gradualist, democratic, social revolution that had been taking place was brought to an end. The new Republic of Ireland, which through its exports (including population and the repatriation of their earnings) had shared in the new prosperity, stayed out of the war.

Until the second world war the English genius for gradualism had solved national problems pragmatically as they were recognised. Housing, schools, hostels, health, education, social and welfare schemes, appeared piecemeal in response to need. The great majority of the hospitals that form the National Health Service today, and the many that have been recently closed, were built and run by Charitable Trusts. Indeed much of the accommodation built for rent to the working classes had been brought about by non-profitmaking Housing Associations. The advantage of such fragmentation was that where errors were made they were, in contemporary terms, small, and cheaply and easily rectified.

In the latter part of the 19th and early 20th century, a generation of utopian dreamers had appeared and began to press their untried theories on intellectual society. Among these was Ebenezer Howard who proposed New Towns and Garden Suburbs as a solution for what he perceived from his privileged middle class background as, the problems of urban living. His and the "machines for living in," "high-density high-rise" theories of Le Corbusier, Erno Goldfinger, and the like were imported from the continent, studied, and advocated without question by progressive academia. Likewise, in the field of economics, the largely unproven theories of John Maynard Keynes and others became part of academic curricula. Generations of students spent their formative years studying, and their working lives implementing, often untested theories now shown to be flawed.

In 1945 Britain came out of the war, encumbered by Empire, assets intact but, in cash flow terms, technically bankrupt. Her people, starry eyed in a mood of social idealism, the pitfalls obscured by wartime propaganda eulogising their glorious Russian allies, elected a left wing Government.

Abandoning gradualism, the new Government embarked on a massive programme of immediate change. Major industries; Transport, Coal, Steel, Electricity, Gas, the Docks (all of which had come into existence, grown, changed, contracted, piecemeal in response to national demand) were nationalised. Management passed to government-controlled bureaucracies, created for the purpose. Previously separate private hospitals were combined to create the National Health Service. Residential rent control, which was to destroy the private rented sector, distort the investment market, and effectively split the nation into either owner-occupiers or Council tenants, was imposed.

The new and entirely theoretical profession of the Centralised Planner came to aid chaos. The low-tech building industry, pulling in labour from abroad, became an economic regulator and by pushing, rather than being pulled by, the economy, may be argued as the major factor in Britain's technical decline. Research and development were sacrificed to fund social goals which would arguably, on prewar precedent, have anyway been brought about more equitably by a high technology, market led, economy of the type applied by far more successful former enemies to gain world markets.

A massive public sector housing programme, implemented on suspect statistics, used blanket criteria – typically "Most slums have rising damp" therefore "All houses with rising damp are slums!" – to destroy hundreds of thousands of easily repairable homes, along with long settled, self supporting, communities – extended families that had previously made little call on the State. The quality of many dwellings demolished, mainly small terraced houses, may be judged from examples that survive. Restored and cherished they continue to offer socially sound accommodation long after municipal products a quarter their age have been demolished or are ripe for demolition.

New towns, taking virgin farmland, much of which might otherwise have remained undeveloped, were largely populated with those displaced from clearance areas. These areas, when redeveloped, were often occupied by tenants from expanding unintegrating cultural groups, who could not have been present when the statistics on which the schemes were justified were prepared. Such schemes, often adding to traffic pollution, can be argued as a major contributory cause of inner city decay and social decline.

Prosperous, in comparative terms – particularly from the late 18th century when the Industrial Revolution's burgeoning commerce and civil works attracted newcomers, particularly from the Celtic fringe – England had long been the destination of those seeking a better life.

Following the Second World War – encumbered with the debris of Empire and housing and social policies which allow those who had not contributed to benefit from national welfare schemes – immigration to the UK accelerated, encouraged by Government labour policies in the sixties and lack of political will since. Typically the Irish Republic, a country with a culturally high birth rate, has tended to export surplus population and with them social and sectarian pressures. The apparently disproportionate number of people of that origin occupying influential positions in media, unions, and politics of the left, often fuelling contention in the UK, while leaving an oasis of prejudiced calm in the area of their origin, results from this. The resurgence in Northern Ireland in the late sixties of IRA-instigated troubles, at massive and ongoing cost to the UK economy, is perhaps illustrative of the influence within the UK of elected politicians and others whose hearts lie outside of the nation's boundaries.

The altruistic English, a tolerant, integrating people, little interested in politics, believing in fair play and seeing the other chap's point of view, witness their formerly stable, low crime, society being destroyed by those who often preach one thing and practise another. Indeed, indications are that, if current population and political trends in England are extrapolated, those who would have been regarded as English in 1939 could, within the first half of the coming century, become a minority in the country that bears their name. Indeed, if the trend, suggested by recent statistics, away from marriage toward poorer social and family values, and the failure proportional advantage of educational opportunity continues, their numbers, even in top management and the professions, will decline.

Initially confined to the upper classes, education spread, through the churches, municipal and charitable foundations, to the lower, and ultimately the working, classes as the needs of Empire, commerce, the military, and the industrial revolution became apparent. In the late 19th century publicly funded compulsory education for all came into being. By the early 20th century, though Public Schools and Universities remained for the rich, a fragmented competitive education system offering equal opportunity to those able and prepared to work, was available to all.

Between the ages of 5 and the leaving age of 14 elementary schools taught the basic skills of literacy and numeracy, the foundation without which further education is impossible. At 11, through open, competitive, scholarship examinations, access to secondary education in local Grammar schools was available. For examination failures considered bright by their teachers, secondary education beyond 14 could be offered through a system of central schools teaching a pseudo Grammar/Commercial curriculum. Also, at 13 a further open examination offered access to technical education. Beyond 16 further education became available at Polytechnics and, to students of proven excellence, through the system of ancient and evolving Universities.

In 1947, following enquiry by the German Government, the British Control Commission arranged for a TUC delegation to visit the Federal Republic and make recommendations regarding an education system suitable to the emerging democracy. Back in Britain the dismantling of the system recommended had begun!

Over the next thirty years – again with the application of untested theories – the abolition of general competitive examinations, Grammar and central schools, and the introduction of the Comprehensive, the destruction of excellence in English education, and with it vast social and economic consequences, came about. The Celtic fringe was less affected. Following concentration on easy subjects, e.g. arts and social, rather than maths and physical, sciences, and the renaming of many Polytechnics as Universities, general Degree standards fell and the system of competitive excellence, which was to stand Germany in such good stead, was finally abolished.

In 1945 – when Britain set out on its programme of social experiment – her major competitors (with the exception of the US) in world markets were bankrupt, devastated by war. Apart from massive natural assets the nation could call on long established, and emerging, industries: automotive, shipbuilding, electronics, chemicals and consumer goods, among others, to lead her fight for world markets. The Empire, though increasingly a burden, and the Commonwealth, offered world wide opportunity for preferential trade. Why then did the UK fail to take advantage of the opportunities offered, falling from second to, arguably, eighteenth in the world economic league, and still declining, over the fifty plus years since the War?

Aside from reasons of social experiment already mentioned, the nation that emerged from the conflict had many historic inherent defects; not least were the profit envy, confrontational nature of labour relations. Unions, rather than seeking ways to work with employers to improve the security and prosperity of their industry, sought to preserve outmoded practices and demarcation lines that, by removing the labour flexibility enjoyed by competitors, ensured their industry's decline. The fact that those Unions, through funding and nomination of MPs, often controlled the party in Government was not without significance.

In the field of commerce and industry the unfettered application of the theory of " Economies of Scale", provenly effective at micro level, may, when applied in major complex situations, be often seen as disastrous. The demise of the British motor industry, via mergers which removed choice and competition between makes, is illustrative of this. Anyone who doubts the validity of this argument may wish to consider the number of competing makes within the Japanese economy and the varied consumer goods, other than cars, produced by the companies concerned.

The consolidation in the sixties of takeovers, corporate mergers, and asset stripping, for the purpose of one-off capital profit, did much to accelerate the decline of many viable businesses: a large part of the nation's industry and the prospect of remedial management-led growth went with them. From the same period, non-market planning policies, Office and Industrial Development Certificates, Development Areas, Expanding Towns, etc. etc. distorted investment, forcing up rents and capital values in areas where industry and commerce needed to be. The importation, from land rich America, and encouragement of out-of-town super stores and shopping centres compounded car use, added to traffic congestion, stealing value from and denuding nearby towns, where those without access to a car often faced rising prices and declining facilities in a derelict town centre, with loss in value and social cost far outweighing any possible gains. Over the same period – as the motor industry failed and foreign manufactured vehicles poured in – government, while adding to congestion by encouraging parking in prosperous inner city areas, ran down declining public transport and implemented major road construction. Typically the Tories' Beeching Plan closed a large proportion of the nation's rail network in the sixties. In public housing, specifications fell and densities rose as politicians built high to win – short term – in the numbers game; creating management, maintenance, and social, problems.

In the wider field of National Government, as Parliament passed invasive, often unwarranted legislation taxation grew and talented people who would otherwise have fuelled enterprise were drawn to strive for status, building ever larger, self perpetuating, bureaucracies; stifling and adding cost to commerce; blunting the Nation's competitive edge in world markets. Typically the reorganisation of Local Authorities, often for political advantage, into ever larger units, removing the easier control and competitive advantage of smaller authorities that had evolved historically in response to circumstance, can now, as the move to reinstate Parish Councils gathers pace, be seen to have been disastrous. In an age where in the private sector the merits of free standing subsidiaries and demergers are becoming increasingly apparent, and beginning to be implemented, the ongoing consolidation of the NHS into fewer ever larger units, by the destruction of proven easily managed and monitored small hospitals, bodes ill.

Equally idiotic, but of far greater consequence, the immersion of the comparatively simple UK into a Europe of Balkan-plus complexity and potential for conflict beggars belief. The fact that small states with high population densities and few natural assets, typically Switzerland, Japan, Singapore, Taiwan, South Korea, and their like, prosper in the world economy, surely indicates that Britain, with its boundary security and massive natural assets, should bring an end to the current foolishness and to great advantage seek its future outside of the European Community.

Today there is a stable housing market with a viable private rented sector emerging. The building industry and interest rates are subdued and there are signs of a thrusting technology-led economic revival. To paraphrase the slogan of a well known charity, the lesson recently learnt would seem to be "Give a man a house and a handout and he'll become a social problem. Give him a job and a chance to better himself and he'll stimulate the economy, buy or rent a private sector house, and become a national asset." However, there is the prospect of an interventionist Government which could repeat the mistakes of the past.

What then is the likely prognosis for the future? Support for Devolution from the substantial Celtic content in any new left wing administration, and waning regard for monarchy, would seem to point to a break up of the United Kingdom. Southern Ireland's Presidency of the European Union and stance on BSE, and other matters, would seem to indicate that Republic's enthusiasm for full integration with Europe.

It also seems likely that a devolved Scotland, with its nostalgic historic links to France, would, joined by Wales, follow the same path. The fate of the enigma that is Northern Ireland remains to speculate, but the sense of any, or all of them breaking links with the provenly benign generous devil they know for the one they don't, to become minor States in a potentially Federal Europe, dominated by France and Germany, must call for wider examination.

What then of England? Whether she stands alone or, more likely, follows the UK's other component parts into an ultimately Federal Europe must be a matter for speculation. A possible alternative is that she and, to their advantage, the others should explore the possibility of common market links with the USA; indeed even to becoming States within that Union. With few language, cultural or unacceptable political differences this, if the UK and Southern Ireland have to join anything, could be argued as the viable alternative not fraught with the obvious historic pitfalls of union with a Europe of multi-cultural nationalistic states. Distance would seem to be no object, Hawaii and Alaska being as far removed from Washington as the UK. As for Ireland's predicament, precedents exist in American history which point to a solution of that problem. While on random enquiry Americans showed little enthusiasm for the idea, indication was that some saw the possible arrival within the Union of sixty plus million former UK and Irish citizens as likely to reinforce the traditional balance in the Congress of a nation which has its own developing cultural and other problems.

OBITUARY

PAUL DERRICK

Paul Derrick died on November 30th 1996 aged 80. He was a long-standing member of the Economic Research Council. In more recent years he was sometimes to be seen taking his seat at the back of the room for the after-dinner talk, a giant of a man in stature, compassion and intellect. He was a lifelong advocate of the co-operative movement and a firm believer in this form of social ownership. He must surely have admired Edward Holloway for his concerns about the way employees were commonly mistreated in takeovers, and about the absurdity of an economic system which led to poverty in the midst of plenty in the late 1920s and early 1930s when the Economic Reform Club and Institute (which became the Economic Research Council) was set up by like-minded people who wanted to do something about it. Where Holloway sought to reform monetary policy, Derrick saw solutions in the way society and particularly industrial society was organised.

In an obituary in The Guardian on January 17th 1997, Philip S. Bagwell recorded that Derrick was a Christian socialist, a lifelong Catholic, and a member of the executive of the Christian Socialist Movement from its foundation in 1960 to 1983 and editor of its journal from 1970 to 1993. He described Derrick as kindly, helpful, and good-humoured with no leisure activities, very little social life, and dedicated to the causes in which he believed.

Through his membership of the Economic Research Council Paul Derrick helped to fan the flame for social and economic justice which it is to be hoped the Council will long continue to keep alight

M.C.

LETTERS

Responses to "Letters – The Money Concept Conundrum" (B&O, Summer 1996) from Mr. Eric de Maré, Mr Lee Cheney and Mr T. B. Haran.

Sir,

The Money Gap

John Dunlop's proposal in your winter issue that we should all share in society's production is sane and sensible. It is in line with ideas that have been floating around for some time for National Dividends or Basic Incomes.

We can now produce a huge increment of wealth that cannot be distributed to anyone, wealth that is the product not of human and animal labour but of machines and technology. Two centuries ago over ninety per cent of a country's working population were needed to produce enough food for survival; today only about two per cent is needed, while farmers are being paid *not* to produce food. One man helped by automated machines can turn out fifteen motorcars a day and so on. Before long with nanotechnology we may be able to make anything and any material without effort from atomic scratch and we may find infinite energy from atomic fusion or the colliding of matter with anti-matter. All with almost no human labour. These developments are the result of a cultural inheritance of the whole human race and so every human being on earth has a right to a share in its products without moral obligations of any sort except to keep the law.

For millions of years survival has depended on human muscles. Suddenly within three centuries the obligatory work ethic has become obsolescent if not yet quite obsolete. No wonder we are finding adjustment hard going; no wonder our culture is in such a dangerous mess. Full Employment in the Workhouse State, the Slave State, is no longer either possible or desirable.

And this is where Mr. Dunlop, together with most other economists, do not face the basic trouble: the world's lack of sufficient purchasing power. Our wage-salary-debt system cannot deliver all the goods. Mere redistribution of available purchasing power by means of a levy on employers for every person employed will not fill that blatant and egregious GAP between available purchasing power and prices of goods and services for sale, any more than can redistribution of incomes by graded taxation. All our troubles lie in the venal debt-tyranny of the banks which maintain their power over the human race as a result of the universal and unquestioned acceptance of the ridiculous Work Ethic. The future of civilization will depend on a joyful acceptance of the liberty of leisure in the security of adequate private incomes for all. Under a sane economy, the function of money would be to reflect facts for the good of the individual, not to impose an undemocratic, power-mad and ultimately lethal, policy based on a false moral code.

Yours truly,
Eric de Maré
Dynevor House,
New Street, Painswick,
Gloucestershire GL6 6UN

Sir,

The debate over the difference between *money* and *credit* seems to be a bit muddied. If you don't mind, I would like to throw a little rock in the mud and see what happens.

Very simply, *money* is an asset. Period. One way or another, *money* is the equivalent of *goods and services*.

So what is *credit*? *Credit* is debt/tax slavery. Period … oops, not quite so quick with that period. Credit is debt/tax slavery for everybody except the *creditor*, the person extending, or creating, or giving, the *credit*.

So, what's the problem with an EMU?

The bottom line is that, to date, the debate involves a *credit* based EMU that is bogged down in interest, debt, and taxes for everybody (except the *internationalists* – the owners of that *credit*), who remain obliged to feed these *internationalists* the very wealth they worked so hard to create, which the *internationalists* get in exchange for the very interest payments, mortgage payments, and tax payments paid to these *internationalists*. You know, the old rich get richer and the poor get poorer scenario that is the bottom line blocker to an EMU.

Let's look at taxes. Everybody knows that no nation can exist without taxes, right? Wrong! What if the government printed the money *as an asset* instead of letting the bankers create *credit* to be loaned to the government, to business, and to the people?

Which government would print the money? Who would own it, and who would make the spending and investing decisions? Can anybody envision interest free, debt free, and tax free national and international, trade *of the people, by the people, and for the people?*

In my new little book entitled *Thou Shall Not Steal by Taxation,* I argue that all taxation, of any kind, is a violation of the 7th Commandment of God and I also provide an alternative to debt/tax slavery money that those who are not happy with a *credit* based EMU might be interested in looking at.

Just a little rock in the mud.

Lee Cheney
1415 E. Pecos Dr.
Hobbs, NM 88240 USA

Sir

The Monetary Concept Conundrum

In his letter in the Summer 1996 edition, Mr John Tomlinson sets out his understanding of what the money supply is and how it grows. As, however, that understanding is unsound, it is desirable that a factual explanation should be put on record to replace it.

People trade solely in services, whether their jobs are productive or otherwise. As a result, we pay nothing for the material element in goods; we pay only for the work performed upon it. In other words, goods are a by-product of the system of trading in services.

Consequently, my definition of money is a credit in services of one party (a service creditor) and a debt in services of another (a service debtor), measured in a unit of account, in our case, the pound.

By defining money as anything which acts as a medium of exchange, a unit of account or a store of value, the economics profession have sought to transfer the properties of the services to the measure. This is equivalent to defining therms as gas and title-deeds as houses.

They should have realised that there are, in effect, two types of money, (1) basic money (credits and debts in services) and (2) nominal money (media of exchange and bank deposits).

Basic money is intangible and its existence has to be evidenced in some way. Its creation is shown by payments from service debtors (borrowers) to service creditors (savers) and its destruction by those in the opposite direction. Payments between parties of like status alter the constituent parts of the basic money supply, but leave its quantity unchanged. Total service credits (savings) always equal total service debts (borrowings).

There are two separate processes, (1) the trading activity and (2) the settlement system. Basic money belongs to the former, nominal money to the latter. Bank lending is a later development of the settlement system, the sole function of which is to facilitate trade.

Savings have to be held in three ways, cash, deposits or financial investments.

Accordingly, an accounting formula can be drawn up showing how the quantity of basic money would appear, if it could be calculated, given that all parties are net service creditors or net service debtors.

Service Credits – £billion		**Service Debts – £billion**			
Cash	60	Gross Indebtedness			2,220
Deposits	990	*less*	Cash	40	
Investments	1,020		Deposits	80	
	2,070		Investments	100	220
less Debts	70				
	2,000				2,000

The figures are for demonstration purposes only. Foreign currency holdings are excluded, as they relate to the basic money supply of other nations, but sterling balances owned by foreigners are part of Deposits.

The value of the formula lies in the facts, (1) that the effect of any transaction can be revealed by it and (2) that the efficacy of any monetary concepts can be judged against it.

Do banks create money by lending? Arthur, a service debtor, borrows £100 in cash from his bank – no effect. Gross Indebtedness rises, but so does the Cash deduction, both on the Service debts side. Bank lending has not created basic money. Arthur pays £100 to his landlady, who has a creditor bank balance. Service Credits (Deposits) and Service Debts increase to the same extent. Basic money is created by debtor spending on creditor services and is destroyed by creditor spending on debtor services.

Borrowers incur two debts, one to the bank in terms of cash, and the other, on spending, to the community in terms of services. They have to perform reciprocal services to obtain the funds to repay their loans. Thus, it is trade which affects the economy, while bank lending merely facilitates the trading activity. There can no longer be any doubt. Banks do *not* create money by lending.

Mr Tomlinson describes total money supply as bank deposits plus notes and coin outside the banking system. All of these, however, are nominal money and not the real (basic) kind. His contentions fall, therefore, at the first hurdle.

Taking cash first, we say that we draw banknotes from the bank. In fact, service creditors buy them *with basic money* from the Bank of England via a bank or other intermediary; service debtors also buy them, but the basic money they use is borrowed. The banknotes themselves cannot, therefore, be basic money.

In truth, they are purchasing vouchers for general purposes, just as a luncheon voucher is for a specific one. The position would be clear if each stated that it was exchangeable for its face value in services. The same argument applies to coins. Thus, both types of cash are media for the exchange of services and have no other function. Basic money is the store of value.

If Britain became cashless, service creditors would add any holding of cash to deposits, while service debtors would use theirs to reduce indebtedness. The new total for deposits would be smaller than the old one for cash plus deposits. Part of Mr Tomlinson's money supply would promptly vanish!

The true situation can be checked by reference to the accounting formula. Returned cash would disappear from both sides, leaving the totals unchanged and the formula, as always, in balance. Deposits would, of course, have risen by the extent of the cash paid in, while the fall in Gross Indebtedness would be compensated by the lesser deductions.

In trying to prove that banks create money by lending, Mr Tomlinson sets out a series of examples, which result in an increase in deposits. He attributes the cause to bank lending, whereas he has happened upon the reflection of the process by which basic money is created, that is, debtor spending on creditor services. The fact that the other process, by which basic money is destroyed, creditor spending on debtor services, is going on at the same time is ignored. There is, therefore, no justification on any grounds for believing that the build-up of deposits is due to bank lending.

What then causes this build-up? Under barter, trade and settlement are simultaneous, but nowadays there is a widening gap between them. The massive supply of goods and services is financed by bank borrowing before we buy them and we are not often asked to pay in advance or to make stage payments for work in progress. This situation allows deposits to build up and to create the illusion that the money supply is increasing.

In addition, many services have already been provided, but the bills, such as for electricity, have not yet been presented. Allowance is made for this in the accounting formula by the deduction for Debts under the Service Credits side.

There are still some funds available for lending and these are taken up by people who wish to live beyond their current means and buy houses, cars, consumer durables etc. with loans.

What is the part of the banks in these procedures? The true situation can be explained by way of analogy. Cars are manufactured and scrapped; the comparable process is the creation and destruction of basic money. Some cars are acquired by garages and rented out; the banks collect basic money and lend it. The cars are continually returned to the garage; basic money keeps coming back to the banks as deposits or repayments of loans. No creation of any kind takes place in either the renting or the lending practice.

The build-up of deposits does not stop with the settlement procedures. Accounting systems can cause a proliferation of deposits, which are clearly not related to purchasing power. Banks, for example, maintain creditor accounts (Bankers' Deposits) with the Bank of England, the contras of which are debtor accounts in their own books; thus, the balances at the central bank are not deducted from the deposits from which they came and are double counted. Indeed, this situation happens when any deposit-taker has a creditor account with another. Other balances in the proliferation category arise when parties, such as building society borrowers, have creditor accounts elsewhere, which could correctly be set against their indebtedness.

The worst feature, however, is the practice of adding in the sterling value of foreign currency balances *held abroad*, that is, the deposits of other nations. Four cross entries are needed to achieve this form of creative accounting!

For all these reasons, deposits are very far from being purchasing power and their real function is simply to serve as bank records. Purchasing power is actually the part of deposits savers intend to spend plus the part borrowers have obtained for the same purpose.

The banks did not create any money by lending during the period from 1971 to 1995, nor at any other time, and certainly not the £559.5 billions attributed to them by Mr Tomlinson. It follows that bank lending cannot be a destroyer of savings, far less, as he claims, the principal one.

In truth, bank lending has been a great boon to the human race and has enabled us to achieve a standard of living, which would, otherwise, have been well out of reach.

The monetary system itself has been honed to near perfection by generations of bankers, whose expertise has baffled the economists. Thus, it is not monetary measures, which are needed to manage the economy, but actions which influence the terms of trade.

Monetary theory is in a sorry state. Our universities are teaching false concepts, the monetary authorities are basing their practices on unsound principles and the media ensure that no-one escapes the indoctrination.

Economies, however, are run by business and industry and not by governments or central banks. Consequently, they always function to some extent, though not always in the national interest. It is, therefore, these shortcomings, which need to be dealt with.

Accordingly, I am of the opinion that the reputation of the Bundesbank has been built on myths and the simple fact is that German business and industry have outperformed ours.

Incidentally, my book – The Monetary Analysis – is presently out of print, but some copies are available from Messrs A L Fleming, 12, Salisbury Road, Bromley, Kent BR2 9PY, price £14.95, plus post and packaging.

Yours faithfully
T. B. Haran
Grianan
23 Orchard Road, Bromley,
Kent BR1 2PR

A Contribution, originating from the UK, but provided by an ERC member in Canada where it was published, who felt that "B&O" readers would appreciate the chance to read it also.

Sir

We are survivors! (for those born before 1940…)

We were born before television, before penicillin, polio shots, frozen foods, Xerox, plastic, contact lenses, videos, Frisbees and the Pill.

We were born before radar, credit cards, split atoms, laser beams and ball point pens; before dishwashers, tumble driers, electric blankets, air conditioners, drip dry clothes … and before man walked on the moon.

We got married first and then lived together (how quaint can you be?). We thought 'fast food' was what you ate in Lent, a 'Big Mac' was an oversized raincoat and 'crumpet' we had for tea. We existed before house-husbands, computer dating, dual careers; and when a 'meaningful relationship' meant getting along with cousins and 'sheltered accommodation' was where you waited for a bus.

We were before day care centres, group homes and disposable nappies. We never heard of FM radio, tape decks, electric typewriters, artificial hearts, word processors, yoghurt and young men wearing earrings.

For us 'time sharing' meant togetherness, a 'chip' was a piece of wood or a fried potato, 'hardware' meant nuts and bolts and 'software' wasn't a word.

Before 1940 'Made in Japan' meant junk, the term 'making out' referred to how you did in your exams, 'stud' was something that fastened a collar to a shirt and 'going all the way' meant staying on the bus to the terminus.

Pizzas, McDonalds and instant coffee were unheard of. In our day, cigarette smoking was 'fashionable'; grass was mown, 'coke' was kept in the coalhouse, a joint was a piece of meat you had on Sundays and 'pot' was something you cooked in. 'Rock Music' was grandmother's lullaby, 'Eldorado' was an ice cream; a gay person was the life and soul of the party and nothing more, while 'aids' just meant beauty treatment or help for someone in trouble.

We who were born before 1940 must be a hardy bunch when you think of the way in which the world has changed and the adjustments we have had to make. No wonder we are so confused and there is a 'Generation Gap' today … BUT BY THE GRACE OF GOD … WE HAVE SURVIVED.

Food for thought.

PS I can not claim total originality but some of the above may prove of interest to our readers

John E. Simons
Braeside Guest House
Kilmore
Oban

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.

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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').
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APPLICATION

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

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 *(delete those non-applicable)*	Individual membership (£25 per year) 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 ....