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THE DANGERS OF INADEQUATELY CONSIDERED CONSTITUTIONAL CHANGE

A talk given by The Rt Hon Michael Ancram QC MP, Chairman of the Conservative Party, to members of the Economic Research Council on Tuesday 1st December 1998

Tonight I want to look at the Constitution because I really genuinely do believe that what is happening to our Constitution at the moment is immensely serious and damaging. It's one of those subjects which unfortunately, when you start talking to people, you see their eyes glaze over and when you talk about concepts like Sovereignty you see people nodding off. But the Constitution at the end of the day is what underpins our Rights as citizens in this country. We don't have a written Constitution, which can simply be amended as the American Constitution has been from time to time and by given majorities. We have an un-written Constitution where our Institutions can be changed by simple majority votes in Parliament and we are seeing at the moment what even in the words and mouths of the Government is a positive cascade of Constitutional reform. In fact I was listening to the debate on the Constitution in the House of Commons yesterday and the Government Minister was saying we will go down in history as the most radical reforming Constitutional Government for at least 150 years.

That would be in a sense fine if – first of all, the British people had been asked and had voted for the changes that are happening; and secondly if I felt that the Government had actually worked out what the outcome of all this reform was going to be. But my fear (and it is not a Party Political fear because it is shared by people in other political parties as well) is that a lot of these reforms have been plucked off the shelf – have not been fully thought through even within their own terms, and certainly not in terms of each other. What we are actually looking at is a situation which could result in the most enormous Constitutional mess. That is very frightening in a country like ours where, as I say, our rights as citizens at the end depend on a clear understanding of the Constitution and the existence of Institutions which are there to protect them.

There are one of two small areas of change which I think two or three years down the road are going to have enormous significance. But I think at this stage I will only refer to them – The Human Rights Bill, the incorporation of the European Convention of Human Rights is actually for the first time in our history asking judges to make political decisions. That may not sound very important but in a system where our judges have always been above politics it does have very serious connotations. If a judge is making a political decision does it matter what the judge's politics are? It probably does. If we are moving down that road, should we not have the type of protection that exists in the United States where there is a Supreme Court which is there and appointed with a whole series of checks and balances so that the politics of those judges can be explored before they are actually appointed? That is a very small example of a reform which has taken place without the implications, and the downstream effects of it being thoroughly thought out.

A much bigger example is what has become known as devolution. I've always, in all the years that I was involved in Scottish politics, believed that devolution was the opening of the door to the break up of the United Kingdom. I said so during the whole course of Referendums in Scotland and Wales when I was the Party's spokesman on the Constitution, and was told throughout that I was out of touch; that I didn't know how the modern system would work and that what was being proposed (in the words of George Robertson) would actually be the death-knell of Nationalism And yet we see, a year down the road from those Referendums, the signs in Scotland of a situation which quite seriously and quite quickly could lead to the break up of the United Kingdom.

Having just come down from a weekend there and having spent two weeks at the end of August talking to a lot of people in Scotland who I'd worked with (I'm a Scottish barrister – I've worked with them in the courts; I've been a Scottish MP – I know them politically; I've been a Scottish Minister) – I found a totally changed atmosphere from that which existed five or six years before, when I left Scotland, because now people are no longer frightened by the implications of independence.

What had happened in the Referendum was that Nationalism had become respectable and we now face the situation where far from Nationalism being 'stone dead' in the words of George Robertson it is actually running neck and neck with the Labour Party in the opinion polls. It is quite possible that at the first Scottish Parliamentary elections next May we will see, if not a Nationalist majority, a very substantial Nationalist vote. It is almost certain that on the back of that they will be able to use the Scottish Parliament in order to try and create a dissension, a continuing air of dissension between Scotland and England and they are very open about it. The one thing I do respect about the Scottish Nationalists is they make no secret about their end goal – and that is an Independent Scotland. They've said that once this Parliament is up and running they are not going to have much power over things which are going to upset the Scots, so they will pass Resolutions on things like whether there should be nuclear submarines in the Gare Loch.

And once they pass that resolution they'll come down to London they'll say to London 'Get rid of these submarines' and London will say 'It's none of your business, it's not something you have any control of' and they'll go back to Scotland and say 'the will of the Scottish people is being thwarted by that English Parliament at Westminster'. They quite openly declare that if they do that every six months they will build up a head of steam and of resentment that in the end will lead to a Referendum and if there was a Referendum the opinion polls at the moment in Scotland suggest that there is likely to be a majority for Independence.

So we are seriously facing a possibility that something we take for granted (which is this unit called the United Kingdom) is actually within the next ten to fifteen years going to break up. We will not have that unit which has given us such a position within the world, which allows us to sit on the Security Council, which allows us to be on the G7. All that will be undermined because of decisions that will be taken on the back of devolution.

I don't make the same claims for Wales. I'm not Welsh but I also was the spokesman for Wales for a year and I discovered in my time in Wales that Wales is very different.

There are two Wales' (if I can put it that way). There is a North Wales and a South Wales and North Wales is more frightened of Cardiff than it is of Liverpool and I don't think we are going to see Wales going down that road. But the momentum of separation which could be caused by a Scottish breakaway, would probably very shortly be followed by implications in Northern Ireland, where I spent four years, where the Nationalists would claim that that was the signal for a united Ireland and the Unionists would claim that the only way now to prevent that is to have an independent Northern Ireland. Already when I left the noises on that were being made. We would also begin to see a reaction in England, I'm already starting to get letters from people saying 'Why do we bother about the United Kingdom?' You know – 'the Scots don't love us'. 'We pay more per head for their children in school, for their health and everything else'. 'Why do we allow this to happen?' And we're faced by another serious consequence of devolution, which became known as 'The West Lothian Question'. The West Lothian Question very simply is an anomaly where Scottish MP's after next May will be able to come to London, and vote on English education, English health, English roads and so on. But they won't be able to vote on those same matters in their own constituencies because those will have been dealt with by a Scottish Parliament. We could eventually see a situation where important issues relating to English education, are actually decided by the votes of MP's from Scotland and Northern Ireland, who have no similar rights to vote on those matters in their own country, and where we as English MP's have no rights to have any influence, either in Scotland or Northern Ireland. When that happens there will be a body of resentment in England that will say 'Why should we have our education, our roads, our health decided by people for whom we have not voted and whom we cannot vote for or affect?' When that happens I think we will begin to see the beginnings of English Nationalism rearing its head.

There are ways of dealing with this – we have explored them all and none of them work. But they're worth just canvassing with you because somewhere out of them I think we will have to find an answer.

The first is that you quite simply designate Bills on English matters as English Bills, and the Scots and Northern Irish don't vote on them. But if you do that you actually create two totally distinct categories of MP in the United Kingdom Parliament and you begin to undermine the concept of the United Kingdom in that way. Second is that you set up perhaps for two days a week in the Westminster Parliament what is known as an English Grand Committee. The English MP's sit dealing with English matters for two days a week, and the other two or three days a week everybody else comes down and it's a United Kingdom Parliament again.

But that has its difficulties too. You'd have to change all the rules about what Grand Committees could do. You'd have to allow the whole of legislation to go through. You might create a situation where the United Kingdom-controlled Treasury was being thwarted by the English Grand Committee. You might also find idiotic situations arising like Saddam Hussein deciding to go to war on a day when the Parliament here is an English Parliament and not a United Kingdom Parliament and what do you do about responding to that? So that too is seriously flawed. A third potential answer which is put forward is the creation of an English Parliament somewhere (say York) – a Parliament of 500 MP's representing England. Just as the Scottish Parliament will represent Scotland. And you retain at Westminster what would then become effectively a Federal Parliament.

My fear is that the moment you have that, somebody is going to wake up and say if you've got a Parliament of 500 English MP's in York and another one of 500 English MPs in Westminster with 150 add-ons, why duplicate? Let's just have the one and we're back on that slippery slope to separation again. So we haven't got an answer to the West Lothian Question. We, the Conservative Party, didn't create the question. We warned what would happen, but somewhere down the road we're going to have to find an answer if we are going to hold this United Kingdom together.

There is one other answer which you will meet I am sure in your own areas, and that's the one that the Labour Government has put forward and it's what they call 'Regionalisation'. What you do in order to create a response to the

West Lothian Question is you break England up into regions. You start by creating Regional Development Agencies (which is what we see going through at the moment). You then set up Assemblies in order to hold those Development Agencies to account because they're quangos. This is the language that is used. We are told at the moment that those local assemblies are going to be appointed rather than elected. But equally we are told by Dick Caborn that further down the road he sees those assemblies being elected and getting many of the powers the Scottish Parliament is going to have. So you end up with England broken up into a series of regions with powers at least akin to those of the Welsh Assembly and probably the same as the Scottish Parliament in due course. But they will be regions which have no cohesion.

I represent a constituency on the very edge of the south west region (just south of Swindon) and I am going to find that I am in a region that is going to have to work along with people from Cornwall where the centre of economic activity is going to Bristol and Plymouth and there is no cohesion there at all. Yet these are going to be created as an artificial answer to a problem which has been created because devolution itself was not properly thought through in the first place.

Just to add one addendum to that thought of regionalisation - this same Minister, Dick Caborn, said that one of the reasons for doing this is because in the end we are going to have a Europe of regions where there will be a European Government and regional governments and this will allow the British Isles to slip easily into that Europe of regions. And we will see the National Governments withering on the branch. So that scenario is the scenario we face at the moment. We haven't got easy answers to it because nobody looked into the future, nobody saw the strains that were going to be created within the union. And the challenge for us now is to try and develop a new philosophy of Unionism which is going to create common interest between the various parts of the United Kingdom again. At least to try and hold together what at the moment has been I think so carelessly unbundled. Devolution is one of the biggest challenges because the life and quality of life we have at the moment can be dramatically changed in many areas of the United Kingdom because of it. I think we have to be aware of that and we have to make sure that in the months ahead we are all pressing for answers to the questions which have been created.

We are at the moment seeing, as you know, the proposal to remove the right of hereditary peers in the House of Lords to vote and thus to effectively end their rights to be Members of Parliament through the House of Lords. In many ways it's very difficult to defend the right of hereditary peers to sit and to vote and to partake in Parliamentary occasions just because they are the sons of their fathers. I think at the end of this century that is a concept which, although it may have had some relevance 50/60 years ago, is one which in the modern age is difficult to defend. But what is not difficult to defend and where we must come from in terms of looking at this reform – is that we need a second chamber and we need a second chamber that is able to say to the first chamber if they do something on the back of a big majority – 'You've got it wrong – you must go away and think about this again.' The way the House of Lords does that is by having a sufficiently independent element to be able not always to have to reflect the political complexions of the House of Commons and therefore to be able to act as that restraint, as that check, as the reviewing and revising chamber. Yet what is happening at the moment is actually removing, although it may seem strange to say so, the only 'independent' element in the House of Lords. Because what will be left after this, are people who are there because they have been appointed by politicians and who are there because they owe their allegiance to politicians. And we will end up with a House of Lords which can merely rubber stamp that which the House of Commons does. Thus the value of the second chamber (which I think is one of the great protections of rights of people in this country) will have been thrown away.

So our argument in the course of this is not that the House of Lords should not be reformed, but that we should start by asking what sort of House of Lords we want to see in the next century. What is it going to do? Could it have a role to play drawing representation from the newly devolved parts of the United Kingdom to create a Unionist focus in the middle of the United Kingdom again. Can we give it more power for instance to scrutinise regulations coming from Europe?

Mr Antram concluded by indicating that there are too many constitutional issues being raised to which too few answers are being given and on which there is not even a serious understanding of the implications of change.

SOMERSAULTS FOR CENTRAL BANKERS*

by John H. Makin

Over the past two decades central bankers have held the uniform view that their primary task is to fight inflation. Few in this exclusive fraternity seem to have reflected on the danger implicit in their uniform opposition to inflation. Specifically, given the amount of independence granted to most major central banks and the tools at their disposal, if all central bankers continue to fight inflation, eventually they will succeed.

Indeed, if they succeed too well – as they have in Japan and as they may in Europe – they will have to stop worrying about inflation and, unless the inflation battle has been conducted with uncanny accuracy, face the danger of an overshoot. Such an overshoot would require overt efforts to reverse deflation. The first sign of such efforts is the strengthening aversion to a strong currency in Europe.

Over the next year or two, world financial markets and economies will be deeply affected by the answer to an important question: Which major central bank will first move proactively to push down its currency? Will it be the Bank of Japan, faced with deflationary expectations of 2 percent and rising? Will it be the European Central Bank (the ECB), designed to be an inflation fighter par excellence, yet coming into existence when European inflation is drifting close to zero or perhaps below when corrections are made to price indexes? Or will it be the Federal Reserve, which initiated rate cuts of seventy-five basis points over six weeks following the end of September to restore the stock market to all-time highs?

So far the most interesting aspect about the behaviour of the major central banks is the inverse relationship between the proactive reflationary measures undertaken and the degree of deflation confronting them. The Bank of Japan – facing the most acute deflationary problem – has failed to follow through on a programme of aggressive monetary expansion indicated on September 9. The European Central Bank and its proxy, the Bundesbank, enacted a modest rate cut of thirty basis points early in December, as European inflation approached zero. Finally, with inflation rates in the 1 to 1.5 percent range, the Federal Reserve cut rates by seventy-five basis points, as noted. Although the Fed's latest, November 17 rate cut was aimed at Brazil, it hit the U.S. stock market.

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* Originally published as *The Deflationary Fear of Inflation* in the AEI 'Economic Outlook', January 1999

Resisting Orthodoxy

Smaller central banks have displayed a willingness to resist the prevalent inflation-fighting orthodoxy of central bankers. The first dramatic example came in September 1992, when the central banks of England, Spain, and Italy, albeit reluctantly, abandoned exchange-rate targets amid a din of forecasts that inflation and ruin lay ahead. That those economies outperformed other European economies while no inflation materialized was remarked on but not analyzed, perhaps for fear that the supposed vice of reflationary depegging might spread among other central bankers like drug use among bored urban teenagers.

Recently, another group of countries, largely unnoticed, has used the modest reflationary pressure from currency depreciation to mitigate acute deflationary pressure. Australia, a commodity-based economy in the midst of a collapsing Asian economy, has allowed its currency to float; over the past year it has depreciated against the U.S. dollar by about 20 percent. As a result, Australian exports have remained competitive; despite the deflationary pressure from weaker commodity prices, depreciation of the currency has helped to stop modest deflation in Australia and turn it into modest 1 percent inflation. In the year to September, Australia had one of the world's healthiest economies, with growth of about 5 percent.

But the characterization of Australia's performance is odd. *The Financial Times*, in a December 4 commentary, terms Australia the 'lucky country.' In the same article Paul Krugman, an advocate of reflation in Japan, calls Australian performance 'nearly miraculous'. That Australia, as a small, open economy, has chosen to abandon the hard-money, fixed-exchange-rate orthodoxy so characteristic of central bankers and has prospered is not a matter of luck or a miraculous event. It simply represents a choice by Australia to shift demand onto its exports by devaluing its currency. A slight reflation in a deflationary world makes sense. Brazil, please take note.

New Zealand offers a contrasting case. New Zealand, which shares with Australia the role of a commodity exporter, chose to raise interest rates and defend the currency – a policy combination that pushed the country into outright recession with negative growth over the first half of 1998.

Among European countries, Sweden's economy has fared better than most. Since September 1997, the Swedish krona has depreciated by about 13 percent against the Euro, while inflation has actually declined. Meanwhile, Swedish growth accelerated from a low of 1.3 percent in 1996 to close to 2.5 percent during 1998.

Currency depreciation cannot work for everyone – unless global deflationary pressures are present. If every central bank undertakes to depreciate its currency by easing monetary conditions, the result is a concerted effort to cause money to depreciate relative to goods. Though usually called inflation, it is more politely called reflation if we start from a negative number or a low inflation number. Reflation is justified when deflation is threatening to accelerate.

That may indeed be the case in today's global economy, and central banks need to reexamine their inflation-fighting orthodoxy in the context of this threat. The drop in commodity prices of nearly 25 percent in a year (as measured by the Commodity Research Bureau's index) and of 9 percent from mid-November to mid-December (after a brief rally late in August after the Russian debacle) suggests that global aggregate demand is still weakening. Producers who anticipate the need to supply more goods normally bid up the price of commodities as they prepare to use them as inputs for intermediate and final goods, which in turn will meet rising demand.

The Entrenchment of Deflation

Since World War I there has been a long wave of generational trends in the behaviour of prices in the world economy. The 1920s saw a reversion to disinflation after the inflationary excesses of World War I. A decade of disinflation and investment-led growth in the United States finally resulted in a stock market bubble that burst in 1929. But deflation really did not become entrenched in the United States until 1931.

In September 1931 Great Britain abandoned the gold standard, and nervous money fled to the United States. Great Britain had already experienced deflationary pressure following the repegging of sterling to gold at an overvalued exchange rate in 1925. The effort to defend sterling's peg to gold led to deflation in the United Kingdom, which finally forced the country off the gold standard in 1931. The funds that flowed to the United States as a safe haven created concern at the Federal Reserve about inflationary pressure in the United States despite the disinflationary environment. Efforts to 'mop up' the resulting excess liquidity turned out to be a serious mistake.

The increased funds flowing to the United States were demanded by nervous households and businesses anxious to hold more cash and less bank money in the uncertain economic environment in the United States. By draining this cash inflow into the U.S. banking system, the Fed precipitated a liquidity shortage and bank failures that in turn caused the money stock to collapse as it dropped by a third. A bank holiday was declared in March 1933, followed by a sharp devaluation of the dollar against gold; the official gold price jumped from $22 an ounce to $35 an ounce. The Federal Reserve and the Treasury finally had to abandon orthodox monetary policy in the deflationary crisis. Thereafter, prices began to stabilize.

The memory of the Great Depression and the deflationary environment led to a postwar emphasis on reflation and the avoidance of unemployment by policymakers. The Employment Act of 1946 essentially mandated the federal responsibility to maintain full employment.

In contrast to the 1930s, the twenty years following World War II were characterized by increasing attention to maintaining adequate demand growth with less concern about the inflationary consequences. This period of U.S. reflation was followed by outright inflation beginning in 1967, when the United States elected to pursue a guns-and-butter strategy with the Great Society and the Vietnam War. The inflation episode persisted until 1979 with rising prices, a weakening dollar, and a growing conviction among central bankers that inflation was the root of all evil. The era of disinflation began at the end of 1979, when Paul Volcker became determined to wring inflation out of the system.

The first dramatic evidence of disinflation came with the unexpectedly large budget deficits after 1983. Revenue estimators had counted on considerably higher inflation than what actually materialized. Lower inflation resulted in lower tax receipts and a larger budget deficit. The Fed maintained its anti-inflation stance throughout the 1980s, and disinflation continued.

A New Deflation?

The deflation of the 1930s spawned the focus on full employment and the reflation of the 1950s and 1960s, which ultimately became the inflation of the 1970s. The disinflation of the 1980s and 1990s now threatens to create the deflation of 1999 and thereafter. Japan's own cycle of reflationary policies in the 1980s followed by disinflationary and, now, actual deflationary policies in 1997 and 1998 proves the dangers of too much preoccupation with past inflations.

Some analysts at the Bank of Japan still explain the bank's passive stance on reflation by citing the dangers of a return to the inflationary bubble economy of the late 1980s. Japan's central bank is to some extent a prisoner of its past. This condition is all the more remarkable because Japan's overlong adherence to the gold standard during the Showa Depression of the late 1920s and early 1930s created problems similar to those faced by Japan today. Not until 1932, when a new finance minister, Korekiyo Takahashi, abandoned the gold standard and followed reflationary policies, did Japan begin to emerge from its own serious depression of the late 1920s and early 1930s.

Central bankers, probably for good reason, have a hard time making the transition from the needs of an inflationary environment to the needs of a deflationary environment. Moderately rising prices and growth or rapidly rising prices and growth are far more typical than falling prices and shrinking output. When world nominal output (the money value of all goods and services produced) is growing with rising output and rising prices, a strong currency and a firm stance against more inflation make sense. The strong currency helps to moderate inflationary pressure from escalating costs and simultaneously helps to attract capital inflows to finance investment, which in turn provides sustained noninflationary growth. In short, when the pie is growing, a watchful stance against inflation is called for, and the pressure to devalue should be absent, with some benefits going to those maintaining firm currencies.

But when world nominal output is falling with dropping output and prices, the need for a weak currency arises. Excess demand gives way to the far less typical problem of excess supply, which may in turn be exacerbated by an investment-led recovery such as Japan's in the 1980s and the U.S. rebound in the 1990s. A weaker currency helps push up demand for excess output while moderating deflationary pressures. Japan's predicament comes especially to mind. If all nations feel the deflation-induced requirement for a weak currency, then money must be depreciated against goods; reflation is called for. Without a gold standard, the option to devalue overtly against gold is absent. Monetary expansion simply propels the average money price of goods and services. That is reflation.

What are the symptoms of this dangerously accelerating deflation? To answer this question, it pays to look simultaneously at the behaviour of interest rates, exchange rates, and stock prices. Normally a strengthening currency and rising interest rates together constitute a sign of economic vigour since upward real returns can generate that observable combination of price movements. Simultaneously one would expect to see stock prices climbing as a reflection of higher expected real returns. Investors in such circumstances would be switching from bonds into stocks as expected earnings rose faster than interest rates. International capital then flows into the country with rising real returns to buy into the higher expected real growth; this process leads to the popular notion that a strong economy means a strong currency. The demand for cash is stable with higher incomes pushing it up while ascending real interest rates quash cash demand and induce substitution into bonds and equities. This situation prevailed in the United States from mid-1995 to mid-1998.

Japan's Lack of Wisdom

The picture changes in a world of accelerating deflation, especially when the government, as Japan has unwisely done, proposes to fight the deflation with more spending and tax cuts. Keynes identified absolute liquidity preference (he never mentioned a liquidity trap) as a situation in which investors have an absolute preference for cash over bonds because interest rates are so low that they expect them to rise. The conviction that bond prices can only fall (or interest rates can only rise) produces a strong or absolute preference for cash. Stock prices too are expected to fall because accelerating deflation pushes down expected earnings as the attendant rising expected of real yields on bonds and cash draws funds away from stocks. In this environment a rising currency and rising interest rates are matched by a falling stock market. This combination has appeared intermittently in Japan over the past several months and signals an urgent need for reflation.

Japan's manifestation of the most serious deflationary symptoms demands a closer look. Japan has made a disastrous policy error by promising to fight deflation with higher spending and lower taxes. Under this plan the weaker the economy gets (and it is getting weaker, as seen in recent reports such as the Bank of Japan's December Tankan survey), the larger the expected supply of bonds becomes. The rise in the expected bond supply supports the Keynesian notion of absolute liquidity preference by reinforcing the idea that bond prices will fall (interest rates will increase) and so funds rush into cash and out of bonds, stocks, and foreign assets. Foreigners can participate in the switch out of bonds and into cash by buying yen, selling Japanese Government Bonds (JGBs), and selling stocks.

The switch out of Japanese bonds and stocks and into cash was given a boost by the Bank of Japan's December Tankan survey, which showed a weaker economy and a jump in deflationary expectations. While business conditions turned out to be even worse than had been expected in September, deflation was stronger. The more virulent deflation, coupled with a further gain in the expected supply of JGBs, accelerated the shift into cash and out of stocks and JGBs.

Japan's market pattern of higher interest rates, a stronger yen, and lower stock prices is extraordinary and extremely dangerous – especially if it leads to calls for still more fiscal stimulus from politicians. Such stimulus would only reinforce the pattern of absolute liquidity preference, whereby investors fearing higher interest rates sell stocks and bonds and move into cash. In this environment expectations of deflation rise along with interest rates until investors are prepared to add to their holdings of government bonds instead of cash. Alternatively, the Bank of Japan could promise to buy up all government bonds in an effort to pull money out of cash and into bonds, but the concurrent collapse of the yen – which the Japanese government still fears because of U.S. criticism – will probably prevent this for a time. Meanwhile, the rest of Asia claims to be happier with a stronger yen. Thus an unfortunate confusion arises because the stronger yen is viewed, mistakenly, as a sign of Japanese economic recovery instead of as a symptom of dangerous accelerating deflation.

The proximate reason for the recent upturn in interest rates in Japan is, as noted, the large increase in the supply of government bonds needed to finance a budget deficit that probably will approach 11 percent of the gross domestic product in 1999. This is more than twice the budget deficit as a share of GDP experienced by the United States in the mid-1980s during the worst of its fiscal problems. True, Japan as a large saving nation can absorb an outpouring of government bonds – but at what price?

At 1 percent, Japanese households and investors clearly prefer cash to bonds. The preference is reinforced by Japan's 2 percent deflation providing a riskless return to cash holders that dominates a slightly higher inflation-adjusted return on bonds. With bonds yielding around 1 percent, any prospective investor reflecting on a possible Japanese recovery realizes that Japanese bond yields would return to at least 3 to 4 percent in a rally. An investor who purchased a bond with a 1 percent coupon would lose a great deal of capital in such an environment; this realization has produced the modern-day equivalent of Keynes's doctrine of absolute liquidity preference (a strong preference for cash over government bonds).

The Strength of the U.S. Economy

What about the outlook in Europe and the United States? In Europe a combination of falling interest rates, an appreciating currency, and laggard stock prices suggests that inflationary expectations are falling. Indeed the inflation data imply that this is true, especially in France and Germany. Such a combination pleases the traditionally oriented central bankers in Europe. But declining inflationary expectations can eventually turn into rising deflationary expectations. From that scenario can emerge the virulent combination of increasing interest rates, a stronger currency, and dropping stock prices that has emerged in Japan.

While Europe's fiscal picture is far better than Japan's, the expansionary noises from new, left-leaning governments in France and Germany hint that core Europe's extant budget deficits of around 3 percent of GDP could be expanding. As market behaviour in Japan has demonstrated, more expansionary fiscal policy is a dangerous weapon in an environment of accelerating deflation, where absolute liquidity preference (a decision to move from bonds into cash) is a possibility.

As so often over the past half decade much to the consternation of doomsayers in Europe and elsewhere, the U.S. economy appears to be the most healthy of the major economies. A steady downward drift in interest rates coupled with a slightly weaker currency and a stronger stock market suggests that the world's largest economy – and the one least in need of modest reflationary stimulus – is getting just that stimulus and prospering because of it. The modest weakening of the dollar along with falling interest rates implies that U.S. market interest rates are declining slightly faster than U.S. inflationary expectations. According to the rising stock market, the drop in U.S. interest rates is more of a support to the stock market than the penalty implied by falling earnings estimates.

The uneasy conclusion from a review of economic conditions implied by market behaviour in the world's three largest economies is that the U.S. consumer, willing to increase spending at a rate 50 percent higher than income growth, is standing between a modestly expanding global economy and a possible bout of dangerous deflation. The jump in the U.S. stock market since early October, coinciding with a period of Fed easing, will probably put the Fed on hold at least until February 2 and perhaps beyond, particularly if the stock market and spending growth hold up. But the deflationary pressure in the rest of the world creates exogenous negative pressure on prospective U.S. corporate earnings both by virtue of a lack of pricing power for U.S. producers and by shrinking markets for U.S. products. If global nominal output growth during 1999 falls close to zero, U.S. producers cannot maintain profit margins.

Analysts' expectations for profits for 1999 for U.S. firms imply a 25 percent growth rate of earnings. That would be the highest growth rate of earnings in the entire expansion and, in view of the continued slowdown in the growth of nominal world incomes, looks virtually unattainable.

The currency of the world's strongest major economy, the U.S. dollar, has depreciated modestly over the past several months and thereby has helped to mitigate the downward pressure on prospective profits. This situation challenges the sustainment of the current situation in the United States: rising stock prices, a slightly depreciating currency, and falling interest rates. The currencies of Japan and Europe must depreciate instead to avoid worse deflation.

The Path Ahead

Unfortunately, downward pressure on earnings and an eventual slowdown in consumption spending will probably topple U.S. stock prices before either Japan or Europe proactively reflates. Meeting the conditions for such events is not unimaginable. If U.S. stock prices merely stagnate around current levels for lack of easing by the Federal Reserve, U.S. spending growth is unlikely to revert to income growth of about 2.5 percent. These figures, along with the drag on net exports implied by shrinking nominal incomes in the world economy and especially a sharp weakening of Latin American economies such as Brazil as mandated by the International Monetary Fund, suggest that U.S. growth could easily drop to zero or 1 percent and subsequently below should stock market prices actually fall in a slowing economy.

The Fed will be reluctant to peg the stock market with lower interest rates, particularly if instead of the average Standard & Poor's company earning an expected $50 a share – which at 5 percent yields on ten-year bonds would put the S & P index at about 1,000 under normal conditions – the companies will more likely earn $40 a share with ten-year rates going to 4 percent. The latter outcome also implies an S & P index around 1,000, or about 15 percent below its current level. Should earnings disappoint further, say to $36 a share with 4 percent ten-year yields (which would require another fifty basis points of Fed easing), the S & P index could dip to 900, or more than 20 percent below its current level.

Based on the signs of outright deflation in Japan and approaching deflation in Europe and the tenuous support for continued growth in the United States, one must hope that in 1999 central bankers, especially those in Japan and Europe, will overcome their ingrained fear of inflation and will adopt a more healthy fear of the dangers of deflation. Japan's central bankers, when pressed for reflationary measures, have reverted to a claim that not only do they fear inflation but that the reflationary measures will not work. If a central bank starts to print money and prices do not rise, then absolute liquidity preference has clearly taken over, and a rising demand for cash causes consumers simply to hold the additional money created by the central bank. In short, a central bank afraid that reflationary measures will not work had better get started trying them and pray that indeed they do work.

Meanwhile, there is another reflationary option. The United States, with its modest budget surplus and stable prices, could help stimulate growth at home and globally with a simple across-the-board reduction in tax rates. Lower tax rates always enhance economic efficiency and, augmented by a stable monetary policy, would modestly stimulate U.S. growth while causing the dollar to strengthen. Supporting U.S. growth with tax rate cuts would be unambiguously helpful to the global economy since the firming of the dollar would help to shift demand onto the output produced by weaker economies and thereby help growth to increase abroad while ensuring U.S. price stability.

But U.S. tax cuts, even if possible, are passive measures that will not be decided until next fall. For now, active monetary easing is needed. The Bank of Japan must ease aggressively enough to stop the dangerous accelerating deflation appearing in Japan and Asia. The amount of work left for European and American central banks depends on whether the Bank of Japan can abandon its fear of inflation and expedite reflationary measures. If it fails to do so while Europe remains passive, the Federal Reserve must choose between supporting the U.S. stock market and allowing global deflation to accelerate.

REFEREEING REFERENDUMS

by Stephen Kershaw

Referendums were not normally part of our British political system before the Labour Government was elected in 1997. Since then there have been four referendums and a further four are proposed. Two are vitally important – the question of whether or not the UK should join Economic and Monetary Union with certain European nations, and the question of whether or not to adopt proportional representation as a new voting system in UK general elections.

Economic and Monetary Union

Let us assume that a Labour Government decided to recommend that the UK should join Economic and Monetary Union and that this was confirmed in a referendum. Without fair regulations to ensure that the advantages of *not* joining were equally and adequately explained on television, radio and in advertisements, it is arguable that such a decision could be challenged as invalid.

What is certain is that the long and hard fought for freedom and independence of Great Britain, under its own unique form of parliamentary democracy would be irreversibly undermined. The ability of the British Government and the Bank of England to control the British economy according to its individual needs would have ceased.

During the last 400 years, from the defeat of the Spanish Armada in 1588 right up to the Battle of Britain in 1940 and World War II, Britain has had to fight hard at times to retain its political, economic, religious and personal freedoms.

Is the New Labour Government really aware of what economic *and political* union with Europe would mean? Is Labour's idea of unelected bureaucratic power from Brussels and Frankfurt, together with a European parliament in which Britain would have little power, ultimately replacing our British parliamentary democracy, really so attractive? Is this what the Mother of Parliaments has come to?

Proportional representation

The proposed referendum to decide whether to replace the present system of voting in UK general elections with a new system of proportional representation, is probably second in importance only to the referendums concerning Economic and Monetary Union.

The present system keeps the power to choose candidates concentrated in the constituencies. Proportional representation either makes the constituency less important or virtually irrelevant, depending on the system adopted.

The Commission set up to investigate proportional representation was not asked to investigate the advantages of retaining the present system (which is also the system used in the USA). This so-called 'first past the post' system tends to produce two main political parties, either of which can win a general election. It also gives the electorate the power to remove a political party from government.

Proportional representation, on the other hand, tends to lead to coalition governments often with smaller parties holding the balance of power. This has undesirable consequences because smaller parties do not represent widely held views and often tend to hold extremist views.

It is possible on present general election voting patterns that there might never again be a Conservative government or a Labour government in power. Instead of strong government, we would more likely be ruled by coalition governments which could become almost impossible to vote out of power. This could lead to weak government, frequent changes of government, as in Italy, or coalitions involving small parties with extreme policies.

The need for statutory regulations on referendums

General elections in the UK are governed by strict rules to ensure fairness. Under the Representation of the People Act, the two major parties are given an equal share of television time and radio time for political broadcasts and are restricted to equal expenditure on advertising.

There are, however, no statutory regulations at all for referendums in Great

Britain. For example, the Labour government could spend a large amount of money in promoting the case for joining Economic and Monetary Union while spending no money on explaining the advantages of remaining outside it.

The urgency of enacting a further Representation of the People Act concerning referendums, to ensure fairness before either of these referendums is held, is very clear. This matter should be considered by an electoral commission on referendums as soon as possible, and no further referendums should be held before legislation has been passed.

BILATERAL MONETARY THEORY

by Thomas Bewley Haran,
published by Janus, London, 1998, price £8.99

T.B. Haran's work is well known to Council members through his previous book 'The Monetary Analysis' and through his many patient and effective letters published in the Journal.

Bilateral Monetary Theory extends his basic perception that whilst we normally focus on money as cash/bank balances etc ('nominal' money), the underlying reality is always debts and credits in services between contracting parties ('basic' money). Thus, if A paints B's house and is not paid until the job is finished, A, during his painting, is creating a credit and B is increasingly in debt. If B meanwhile mends A's car a similar reciprocal position arises and the affair is settled. No nominal money, cash or banks have been involved but the basic money supply has expanded and then contracted again during the course of the two men usefully working. Thus conventional monetary theory simply fails to present the full picture of economic activity - it merely shows that part of economic activity which happens to be intermediated through financial institutions.

It would take a review as long as the book itself to adequately explain the implications of looking at money 'bilaterally' and this reviewer will limit things to first of all commenting that this is a book for those who enjoy a clear mind applying pitiless logic to a knotty problem; to then warn readers that the author's views on inflation may prove somewhat unpalatable; and thirdly to offer readers a small sample from the book on an issue of great concern today – the 'Euro'. Pages 95–98 read as follows;

European Monetary Union

A free trading area improves the level of business and benefits all participants, but monetary union is a very different matter. We must, therefore, look closely at its prospective effects.

A currency has to have a home. In illustration, the banking systems in Britain and the United States of America transfer the surplus local funds to London and New York respectively; these funds form part of the sterling balances in the first-named city and the dollar ones in the second; such balances do not leave their home countries.

In Britain, the main service debtors, the corporate ones, come to London to discuss and obtain their borrowing requirements. Most of the major lending is agreed in that city, though sometimes with the approval of a bank head office elsewhere. In London, any funds not utilised are lent overnight to the discount houses, a practice which shows how efficient the system has become. Thus, full use is made of the funds available for lending.

What would happen if we gave up our currency and accepted the proposed euro in a monetary union? Our sterling balances, having been converted to euros, would begin to leave the country.

Where would they go? The answer, at present, is Frankfurt-am-Main. The European Monetary Institute, which is intended to become the European central bank, has already been sited there. In effect, the euro would become a deutschmark in everything but name. Germany would retain sovereignty, while all the other member states gave theirs up.

Surplus local deposits from all over the countries in the European Union would be transferred to Frankfurt. The main service debtors would still come initially to London for their borrowing requirements, but, given our recurring trade deficits, British banks would not own or control enough euros to meet them. The ultimate decisions in many cases would rest with German bankers, requiring visits to Frankfurt which might well prove fruitless. The fates of British banking, business and industry would lie in German hands.

All major financial institutions, such as European banks, insurance companies and discount houses, would have to be represented in Frankfurt. The flight of euros would, therefore, be followed by a transfer of people and jobs to that city. Britain, and her other partners, could find that they had become minor provinces in a German financial empire. None, however, stands to lose as much as we do. Incidentally, the Germans might not welcome the influx of so many – er – Europeans.

At some stage the Germans might move the financial centre from Frankfurt to Berlin, which, in effect, would make the latter city the capital of Europe. Nevertheless, the objection is not to a German city: it is to the movement of balances, people and jobs, together with the impoverishment of the areas they would leave behind.

The interests of the countries at the centre of the common market are not the same as those on the fringes. Germany would gain from monetary union and to a much lesser extent so might France and the Benelux countries, though the high price would be the loss of considerable control over their affairs. The other countries – not just Britain – need to retain their currencies for their own protection. It is simply not desirable that the centre should attract balances, people, jobs and, inevitably, power; the need is to spread the benefits outwards from the centre and not solely in the form of hand-outs.

The bureaucrats are obsessed with harmonisation, whereas only competition can give continuing life to the European Union. In any event, how does one harmonise geography'?

Countries joining the European Union expect to make some concessions, but to have their major interests looked after and strengthened. London, New York and Tokyo are the three main financial centres in the world and invisible earnings are very important to Britain.

Our membership, with the help of our partners, should have been of great benefit to our financial centre and the European Monetary Institute should have been sited in London. Germany has the industry; Britain needs the financial aspects. As events transpired, Germany insisted on the European Monetary Institute being established in Frankfurt-am-Main; moreover, when sterling got into difficulties in the Exchange Rate Mechanism, Germany declined to support it. One might say that these actions were a declaration of financial 'war'.

We are entirely to blame for our economic weakness, but the Germans, instead of acting like good Europeans, chose not only to put their own interests first, but to gain at our expense. They are now pressing for monetary union on the same basis.

The financial war has followed the same pattern as the military one. The Benelux countries have been overrun, France has surrendered and Italy is a half-hearted ally. In these circumstances, Britain can never be at the heart of Europe and we need to seek allies to oppose too much power being concentrated in the centre. After all, the balance of power was the policy which served our nation so well over centuries of history. In Europe, nothing changes.

Our partners should recognise that Britain has many more commitments to the outside world than they do. We have, therefore, to remain an international trading nation and must learn to compete with the stronger ones, such as Japan. We can only do this if we retain control of our currency and economic affairs. The case might be different if Europe were doing better than Japan and the 'tiger' economies.

Unfortunately, monetary union is being allowed to develop a momentum of its own. If then we wish the European Union to be a partnership of sovereign states, we must oppose it now and reject a wait-and-see policy. Otherwise, it is probable that monetary union will take place in the centre – Germany, France and the Benelux countries – in spite of objections from outside. At best, monetary union should be abandoned; at worst, sterling should be retained as an alternative and competing currency to the German euro for the settlement of European and international transactions.

If monetary union is introduced, it is desirable that it should be in part rather than whole, so that the effects can be studied on the smaller scale before too much damage is done. Would the French welcome the disappearance of their currency and the movement of their franc balances, converted to euros, from Paris to Frankfurt-am-Main? Somehow, I think they would soon be clamouring to reverse any decision adopting the single currency.

The economy is a local issue, not a central one. It is simply the sum total of local activities. In general, people live, work and spend in local areas and, when obliged to move, put down roots on a similar basis elsewhere. Every local area, whether in the same monetary area or not, has to compete with the rest of the world for its share of business.

Accordingly, there is actually a case for saying that outlying areas, like Scotland and Northern Ireland, should have their own currencies. In other respects, such as defence, it is desirable to maintain a common front.

Summing up, monetary union is unnecessary, undesirable and divisive. The best solution would be for those advocating it to stop so doing. The probability is that any nation giving up its currency will live to regret that decision.

There are two sides to every argument and I would like to have been able to list some of the points of consequence in favour of the good Europeans. Unfortunately, in the light of the dangers we face, I cannot find any practical ones. Indeed, I believe that only subservience and further humiliation are on offer.

J.B.

BUTTERFLY ECONOMICS

by Paul Ormerod, published by Faber & Faber 1998

What an over-hyped, arrogant and intellectually thin book this is! The dust cover tells the reader that Will Hutton of the Guardian has described it as 'A book of our times, reflecting the new scientific and philosophical preoccupations just as the founding fathers of economics did theirs'. The Spectator apparently called it 'Important and ingenious' and the Investor's Chronicle said 'Ormerod's critique is … devastating'. The New Scientist's review called it 'fascinating and informative' containing 'more about the way real economies work than by reading a bookshelf full of academic tomes'.

One approaches such an object of praise with some reverence. And one must add to this a certain intimidation as the text constantly harps on the idea that the author will not trouble the reader with mathematics, as if to say 'don't you dare disagree with me or I'll bury you in equations and calculus!'

So let us start with one little piece of mathematics (or at least arithmetic) that is on offer. Illustrating the application of probability theory he quotes the so-called Monty Hall problem (*page 70–71*):

> A game-show contestant has to choose to open one of three doors, A, B or C. Behind one door lies a prize and behind the other two, nothing. Suppose that the contestant chooses A. Monty, the host, who knows where the prize is, then opens (say) C to reveal that it is empty and the contestant is then given the choice of sticking with A or moving to B.

Most contestants, we are told, stick with A.

> But switching to door B is always the best strategy to follow, for the simple fact that it doubles the chance of winning the prize.

Well now, the author is right in principle (one only has to imagine the game played not with 3 boxes but with 100 where Monty opens all the boxes except the one chosen and (say) number 73 to realise intuitively that one's best strategy is to swop to box 73) but he is wrong to claim that it *doubles* the chance of winning the prize. In fact it increases one's chances by just under 17%.

So, as purveyor of a new general theory, Ormerod, unlike Keynes, chooses to skip around the mathematics. So we must consider what is far more serious – the principles and ideas presented.

There is one good and original idea – that the results of an experiment on ant behaviour conducted by some biologists might give us guidance on crowd behaviour by humans in economic decision making. The results are applied to various issues – consumer choice, the growth of firms, decisions about divorce, movements of stock market prices, the location of manufacturing firms etc and encouraging parallels are found.

But this is then used to claim that current economic theory considers only individuals acting without the influence of others and that 'Butterfly Economics' is a new approach which at last takes account of the influence which decisions made by each of us affects decisions made by others. (Hence the title taken from a comment that a butterfly's wing flap might lead to a tornado.) One cannot help feeling that this is a cheap criticism of a caricature of 'A'-level economics. In fact economists have always noted the influence of others. Industry theory has long noted the 'economics of agglomeration', macro economics is all about countering moods of optimism or pessimism, Austrian school economics, from Schumpeter through Hayek to Kirzner, is all about competition as a discovery process – each persons moves going on from those made by others beforehand. To say that a 'demand curve' ignores the influence of other people's decisions is to misunderstand the precise definition of a demand curve – which is that it represents demand at one split second in time. Any economist would agree that at even a very slightly later time, after everyone has been affected by various influences including other people's decisions, the demand curve will have moved.

It has long been a criticism of the works of John Kenneth Galbraith that 'his best ideas are not original, though they are unacknowledged' and one feels somewhat the same about Butterfly Economics. In this vein (your reviewer is a Galbraith fan) I enjoyed chapters ten, eleven and twelve showing how success breeds success in both business enterprise and nation states.

But other aspects of the analysis are deeply flawed. Protectionism is held to have fostered economic success in 19th century America and in post war Japan. But did it? More likely (*see James Vestal, Planning for Change, OUP 1993*) it slowed progress as the price of containing social disquiet over the speed of change. Ormerod then supports E.U. protectionism and interventionism. How conveniently in tune with current government priorities!

The chapter seeking to illuminate readers on the changing rates of marriage and divorce considers the moneys involved and the 'fashionability' of divorce but contains not even a rebuttal of the notion that decisions about divorce might be linked to the existence or non-existence of young children. Apparently there are no couples who stay together (or have ever stayed together) 'for the sake of the children'. A world of butterflies indeed!

The book is a jolly run-about presented in a slightly aggressive and carping tone and it is good to have had a chance to review it – before it is forgotten.

J.B.

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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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   Date ....
Economic Research Council
239 Shaftesbury Avenue
LONDON WC2H 8PJ.

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)
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	Student membership (£10 per year)
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NAME...
(*If Corporate membership, give name of individual to whom correspondence should be addressed*)

NAME OF ORGANISATION ....
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ADDRESS ....

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PROFESSION OR BUSINESS ....

REMITTANCE HEREWITH ....

SIGNATURE OF APPLICANT ....

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

SIGNATURE OF PROPOSER ....