BRITAIN & OVERSEAS

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

Summer 1999 Vol. 29, No. 2

Editor: Jim Bourlet

Published quarterly by

The Economic Research Council

239 Shaftesbury Avenue, London WC2H 8PJ

Price: U.K. £15 Australia $35 Canada $35 New Zealand $45 U.S.A. $25 Japan ¥4,000

ISNN 0045-2866

President	Lord Ezra
Chairman	Damon de Laszlo
Vice-Presidents	Lord Biffen Sir Peter Parker MVO Brian Reading
Hon. Secretary	Jim Bourlet
Executive Secretary	Professor Peter Davison

MEMBERSHIP

Membership of the Economic Research Council is open to all who are in sympathy with its declared objects. The minimum annual subscription for individual members is £25 for full members, £15 for Associate members, and Student members £10.

Corporate membership is open to all companies and other bodies, minimum annual subscription £55 (Educational institutions £40) in respect of which they may send up to six nominees to any of the Council's discussion meetings and lectures.

Executive Committee

Damon de Laszlo (Chairman)	Robert McGarvey
Tony Baron	Dulcibel McKenzie
James Blake	Christopher Meakin
Jim Bourlet	John Mills
Peter Davison	Alan B. Parker
Peter L. Griffiths	John T. Warburton
John Hatherley	

CONSERVATISM ADRIFT. HOW THE LESSONS OF 1974–79 THROW LIGHT ON THE POST – 1997 ERA.

Extracts, with questions and answers, from a talk given by Sir Alfred Sherman, economic advisor and journalist, to members of the Economic Research Council on Tuesday 8th June 1999.

How is it that the Conservative Party, which seemed to have taken off and soared into the air in 1974, came to earth so dismally in 1997? What happened? What went wrong? And when? In contrast to the generally held view which answers these questions in terms of events and disappointments towards the end, I think that Margaret Thatcher and the Conservatives lost the game in the first two years – whilst in opposition.

Tactical mistakes

In theory, whilst in opposition, a party looks over its past, analyses the cause of its mistakes and works out fresh new policies. Whilst in office you are so constrained by the civil servants, that you always do less than you hoped to do so that what you don't prepare in opposition you will never do in Government. In 1974 Keith Joseph always used to say 'let's wait 'til we get in office and see the books' but this was nonsense because there is very little to be learnt in office that is not known beforehand. In opposition nowadays, a party is prisoner of its own past, and it is hard to admit mistakes and make new policies. I remember Ian Gilmour saying 'we should never say anything which might even *imply* the Conservative Party has been wrong while in office' but unless we use opposition to break with the past errors they are repeated when we return to office.

Margaret Thatcher, a woman of beliefs rather than ideas, became leader of the party. But the Margaret Thatcher of the speeches she then made (I think they were very good speeches, but I'm not objective) and the Margaret Thatcher of policy or lack of policy, were almost two different people. When I suggested that she should sack Chris Patten and Adam Ridley and the rest of the CRD in order to put into it people who shared her views, she was advised against this 'because it caused bad feeling', so she went on and, as a result, her general staff was working for the enemy! I said that we needed several hundred advisors, unpaid while we were in opposition but to be brought in, in office. They would be prepared for their posts (unlike ministers) and put anywhere so that we wouldn't have to depend so much on the civil service. (I was encouraged in this by Bernard Donahue (now Lord Donahue) who used to brief me on the iniquities of the Civil Service). But somebody said 'No, we shouldn't do that – the civil servants are honourable men.' So they are, but that is beside the point.

Policy mistakes

A central point concerns the amount of money which the Government spends. In line with Colin Clark I argued that we should cut down to 25% (of National Income) but they said 'Yes, but what about the great things the welfare state gives'. Now there are arguments for and against redistributive taxation but we have *recycled taxation* which is very different, and very wasteful. Cutting expenditure means sacking civil servants and so we entered 1979 without any policy on cutting government expenditure.

In 1976 I produced a lecture for Keith Joseph for the Stockton Lecture at the London Business School, "Monetarism is not enough", in which he explained why monetary squeezes could not suppress inflation – because inflation is generated by economic policy and monetary squeezes merely harm the private sector. Margaret Thatcher wrote a very favourable foreword to it praising him to the skies and we thought that was Conservative Policy – but I later learned that she hadn't actually read the foreword before she signed it! Then, in 1979 she was unwise enough to depend on Geoffrey Howe and Adam Ridley and the other pseudo-intellectuals and continued (in fact increased) the squeeze which Dennis Healey had adopted in return for an IMF loan in 1976. By the time Alan Walters was appointed as economic advisor, a great deal of damage had been done.

After the 1984 Election (which they would have lost if it hadn't been for the Falklands War) they carried on with the neo-Keynesian squeeze which weakened the private sector and strengthened the public sector. They carried on expanding university education without any relationship to the amount of talent available for teaching or studying the needs of the economy. They carried on pumping probably half a billion pounds into the coal mining industry, because they didn't want to face the miners. The momentum was decreasing the whole time.

The tide of events

In 1983 Margaret de-Shermanised the Centre for Policy Studies, which I think had injected some thought into at least the fringes of the Conservative Party, and from then on it seemed that 'thinking may be dangerous to your political health'.

The down turn was faced then. First there was the question of local government finance. The Poll Tax was inevitably unpopular with those adversely affected. On expenditure they failed to tackle many things, including the enormous number of properties held by local governments. The political management of properties leads to a vast hidden cost to which the only solution is to privatise. Reform was not done because 'we depend on local Conservatives who are in local government and they wouldn't like that'.

And of course on Europe she went along with the pro-Europeans, and when one day she woke up to see what a mess it was and made the Bruges Speech, the Europeans like Geoffrey Howe and others worked together, with their colleagues the yellow Mafiosi in Brussels and Italy, to trip her up.

A conclusion?

The Conservative Party is one of the institutions in Britain which can't be improved from the outside and seems incapable of reforming itself from the inside. I don't know where salvation will come from. The Labour Government by contrast makes a good impression – I'm not saying it's actually doing anything good, but I'm saying they make a good impression. They give these bouncy speeches 'we're going to tackle this, that and the other' and they get credit for the speech in both senses – you get praised for the speech now and you have to pay some time in the future. But they do use these phrases which once made Margaret Thatcher popular.

If things go bad in a country for a long time you feel that there must be some underlying cultural weakness which permits it to be so. And we have to ask what the cultural weakness is in Britain – a country which in the 18th and 19th centuries ruled a quarter of the world, became the workshop of the world and was looked to by the rest of the world as an example. What makes it such a poor limping place? I don't intend to give you the answer. I can only say that something more than economic theory is the key to our economic problems.

QUESTIONS

Q. Is the Conservative Party destined to split into two over Europe?

A. I doubt it – because in the Conservative Party very few people are interested in ideas. Being a Conservative is a form of 'being' rather than 'thinking'. Very few felt strongly enough about Europe to leave before and very few feel strongly enough in favour of Europe to leave now.

Q. *You spoke about Margaret Thatcher's effect on local government but she did disband the GLC.*

A. Disbanding the GLC was a good thing. But all the people and functions went into the boroughs so local government expenditure in Greater London was not diminished.

Q. *How did the Poll Tax become government policy, against what must have been a vast amount of opposing advice?*

A. I was out by then, but I suspect the cause was that power had gone to Margaret Thatcher's head and she didn't listen to anything she didn't want to hear.

Q. *Surely some people would say that the early squeeze was anti-Keynesian?*

A. This was an archetypal squeeze, the sixth, of which three had been under Labour and three under the Conservatives. It's true they used Freedman-like rhetoric for it instead of Keynesian rhetoric. Monetarism really is Keynes.

Q. *Surely the 'Lawson Boom' was caused not by printing money but by uncontrolled autonomous credit growth?*

A. It wasn't only that. The proceeds of privatisation were spent buying popularity rather than creating new assets or cutting down government debt. And also there was the effect of shadowing the Dm.

Q. *Do you think that Margaret Thatcher's 'soft attitude' to education expenditure came from her background as Minister of Education?*

A. Because she had compromised herself by closing Grammar Schools she just wouldn't listen to arguments in favour of selection. The idea of limiting university expansion was unpopular with her – and you have this enormous education lobby where every lecturer wants to become a professor.

Q. *Is there any alternative to using high interest rates and high exchange rates to rein in inflation?*

A. Yes. The Government should not create so much purchasing power. The Government sector is 40% of the total economy and it is the main spring of inflation. So on the one hand the Government spends more in order to buy popularity and then it puts on the financial squeeze in order to restrain the inflationary effects. It's like driving a car with one foot on the accelerator and the other on the brake.

Q. Do you think that devolution will break up the United Kingdom?

A. It is difficult to say – and beyond my scope. The nationalist movements in Wales and Scotland were managed to channel general dissatisfaction. The Labour Party is a corrupt oligarchy of the Celtic Fringe and the whole of devolution is a fraud. The Scottish so-called Parliament merely has the powers which the Secretary of State for Scotland had and they are not going to get any extra money. So after they've had all their bagpipes, and kilts and leeks and other things they will find they're no better off. So they'll switch their anger against somebody else. The English meanwhile grin and bear it. There is no strong measure of English nationalism so far. What will happen in the future you can't forecast because any attempt to forecast moods of cultures and philosophies always fails.

Q. What do you think ought to have been done to get the growth rate up?

A. Cut Government expenditure.

Q. But our competitors like Germany and France have tax rates that are even higher – at 45 to 50%.

A. Well – look at Germany – it's a mess.

Q. How do you cut Government expenditure?

A. You should re-adopt the principle that only the better-off pay taxes. That will limit the amount of taxation you can raise and the amount you can spend. I think the public is ready to hear that. They have had 50 years of runaway taxation and they are ready to listen to that.

Q. What is the underlying cultural weakness?

A. It's hard to say, though I can see manifestations of it. The education system has declined. The classical education, which in my view produced people with a sense of history and vision, has been cut down enormously. The culture has never caught up with the need to value commercial success. We have a welfare-state culture and that's a major influence.

Look at the welfare state. It is wrongly portrayed as having solved problems. If you listen to any socialist they'll give you the history before 1945 as absolute gloom and doom until suddenly along came Beveridge and Keynes which created a wonderful situation. Then they say 'well nowadays of course things are terrible'. They never explain why their wonderful welfare state of 1945 landed them in this awful mess. It is excessive belief in the power of government to do good which underlies this. All learning of history before socialism saw the state as an evil which had to be kept in check but now they see the state as a saviour which has to be expanded.

Q. If we cut public spending, what is going to happen to education and hospitals?

A. We spend four times more in real terms per child on education than we did in the inter-war period and we get worse results. Therefore, lower the statutory leaving age back to 13 because past that age you can force children to attend, if you're lucky, but not to learn. Cut down the number of so-called universities. Cut down on welfare, stop so-called asylum seekers, because with six billion people in the world – most of them ill-treated – most have a good excuse for coming to Britain and we're being choked by them. On health you have to say that people who can afford to pay for their health should do so directly rather than through NHS contributions.

Q. I can think of no other country in the world today which consciously denigrates its history and culture but it has not always been so. How has this come about?

A. In 1945 George Orwell wrote about what he called Negative Nationalism, the self-hate of the intellectuals for everything British – so the phenomenon goes back some time. It may have been the result of the first world war which was a disastrous war which had shaken British Society to its roots and from which we in Europe haven't yet recovered. And let me say that war was partly caused by mistaken policies of Palmerston, Disraeli and Salisbury who were all anti-Russian, anti-Balkan Christian, pro-German, pro-Austrian. And so they built up the Moslems and the Germans and the Austrians until they were strong enough to attack Russia and France. And if Palmerston had not ill-advisedly gone in for the Crimean war, and if they'd not followed anti-Russian policies until about 1913, things might have turned out differently.

The British at the moment as you say (as we all say) are suffering from the intellectual classes who are anti-British, always looking out for reasons to think the worst of Britain. But I believe that if the British people are given the right leadership they could do wonders. I did my best in 1974/75 to create that leadership and guide it. I failed and now I look around and I don't see where it is going to come from. Each of us has his job to do in a small way and our prayers will add up to I know not what.

THE FAULTLINES THAT COULD DESTROY THE EURO

*by Brian Kettell**

On January 1st 1999 Europe launched the Euro, in what will inevitably become known as the greatest monetary experiment in history.

The launch of the Euro with the scheduled phasing out of eleven European currencies by 2002 was accompanied by a great fanfare. Within this monetary experiment there are however the seeds of a troubled later life.

This article describes these seeds, individually manageable, but which maturing together could herald a financial market breakdown, the extent of which the world has never seen. Faultlines range from problems associated with the lack of political union within the EU to the ultimate empirical and intellectual discrediting of the whole idea, in turn leading to a mutual agreement to dissolve the system.

1 Survival Depends on Political Union

Monetary unions of large sovereign nations which do not have political union have from a historical perspective eventually failed albeit sometimes after a long time.

Simultaneous political union is necessary for a monetary union to succeed over a long period. The reasoning for this needs to be explained. The explanation is to be sought in the need for someone to be accountable for inflation. When there is one government, one central bank and one money, it is obvious where the responsibility for inflation lies. In the final analysis, it rests with the government of the country concerned.

By contrast, consider the situation proposed under European monetary union where there are several governments and a system of separate national central banks that are subordinate to a Frankfurt based European Central Bank. Who is to blame for inflation? Is it any one government? All of the

* Senior Lecturer, London Guildhall University

governments taken together? Or is it only the European Central Bank's fault?

The single currency project creates the so-called "free-rider" problems, where governments and nations can act irresponsibly and put the blame elsewhere.

The conflicts could be resolved if the European Central Bank were fully accountable to a single parliament and if there were one government which has to take the exclusive blame for inflation.

2 Euroland is not an Optimal Currency Area

Economists have long debated the conditions required if an area is to enjoy the advantages of a single currency without suffering unacceptable costs as a result of the loss of monetary autonomy for each constituent country within the area.

These can be put under the following headings:

- Capital mobility and diversified asset holdings by residents.
- Fiscal flexibility within regions or transfers between them..
- Labour mobility and/or wage flexibility.

The US possesses all three of the broad categories of internal adjustment. So, for example, if a situation is imagined in which Texas is suffering a negative shock as a result of a sharp drop in the oil price while at the same time California and other states are booming, a number of different mechanisms would cushion the negative impact. The mechanism for this adjustment would take place via three systems of adjustment.

i. Many Texan residents own both directly and indirectly (through pension funds) very significant assets (especially equities) in other states. So any shortfall in their income resulting from an asymmetric shock could be offset by drawing on their diversified asset base.
ii. Given the strong US tradition of labour mobility, many Texans would – if necessary – be willing to move to other states in search of a job.
iii. The third important adjustment mechanism would be the US federal tax system which serves to redistribute income and thus to soften and spread the negative impact of any asymmetric shocks.

As a result of the efficient operation of these three adjustment mechanisms Texans would be unlikely to complain that the US dollar and the monetary policy of the Federal Reserve were responsible for their woes or an impediment to their recovery.

It is quickly apparent that the position in the EU after monetary union is significantly different. Most residents of the EU countries participating in EMU do not have significant equity assets outside their own economy. Labour mobility across borders is much less pronounced in Europe than it is across state boundaries in the US, not least because of greater language barriers. In the US, 17% of the labour force relocates each year, a quarter moving as far as to another state. In the EU only 2% of the population even live outside their country of birth.

On the fiscal side, the contrast is even starker. Whereas the US federal tax system provides a substantial degree of insurance against the income effects of asymmetric shocks, the EU has no equivalent system of federal fiscal transfers. The EU budget at $100 billion, 1.2% of GDP is tiny by comparison with that of the US federal government. Recent estimates are that 1997 total federal spending reached 22% of GDP.

3 Credibility of the European Central Bank

With effect from January 1st 1999 the European System of Central Banks (ESCB) sets interest rates for the whole Euro area. The ESCB is made up of the European Central Bank (ECB) and national central banks in the EMU area. The main aim is to maintain price stability. The proceedings of the meetings of the Governing Council are confidential and there is invariably concern that this lack of transparency will make monetary policy changes more disruptive than need be.

The ECB is not allowed to take instructions from Community institutions or bodies, any government or from any other body. This was formally established in the Maastricht Treaty. Its accountability to the European Parliament is limited. The members of the Executive Board will be on eight-year non-renewable contracts while the national central bank governors come from independent central banks and are on minimum five-year contracts.

Under EMU with 11 member states and with the Governing Council consisting of 17 members, decision making with such a large committee will be difficult. Given the potential difficulty in arriving at consensus solutions there could be considerable inertia in agreeing policy changes. The risk is, therefore, that the ECB Governing Council will tend to be “behind the curve”, keeping policy too tight for too long and too loose for too long.

4 Speculative Currency Attack Up To and After Year 2002

Now that the Euro has come into existence the financial markets are faced with a new risk, one of which they have no prior experience and for which the ramifications are enormous. This risk, known as legacy risk exposure, is the possibility and consequent implications of the withdrawal of a member state from the fixed Euro parity. This is quite different from the withdrawal of a member state from the European Monetary System where individual currencies still existed, albeit nominally pegged to each other.

Voting into power a party which proposes to lead that country out of EMU may be extraordinarily reckless and dangerous but there is no doubt that, while member countries remain independent democracies, it could happen.

How could this happen and what are the implications? One line of reasoning starts with an examination of unemployment within Europe. France has 12.5% unemployment. Suppose that by March 2002 France's unemployment rate has risen to 17%. Assume the National Front makes unemployment the keystone of its policy. Its strategy, let us say, is to leave EMU, reintroduce and devalue the New Franc by at least 20%.

Assume the National Front is not elected to an absolute majority in the French Parliament. However, no alternative party can survive in government without its support. It imposes EMU exit as a condition of participation in government, and another would-be governing party accepts.

French residents foreseeing the threat of devaluation will take all their money out of bank and savings accounts, and put them into Euro accounts abroad. They will borrow as much as they can in France, and re-deposit the money offshore. The classic hedging technique of having liabilities denominated in weak currencies and assets denominated in strong currencies will be applied.

There will be a credit explosion in the EMU banking sector. As the speculation gathers speed it will become clear that the banking system will collapse (i.e. French banks will run out of liquidity) unless action is taken immediately. That action must be an immediate EMU exit – nothing else will halt the flows. France exits precipitously.

5 Mass Unemployment and Europe-wide Recession

Because the ECB wants to show it isn't a toothless tiger it may go for a strong Euro and high real interest rates, exacerbating already high unemployment and kicking the region back into recession. The principle that 'one interest rate size fits all' is unlikely to work when you have a situation where unemployment in Germany is larger than the total population of Ireland.

6 Asymmetrical Shocks to One or More Country

The whole future of the Euro could be threatened if individual governments pursued expansionary fiscal policies. In an endeavour to prevent this, member governments signed the Stability and Growth pact in June 1996 at the Amsterdam summit. This allows a country faced with an annual fall of 2% or more in GDP to ease up on the Maastricht criteria and spend itself out of recession. A big enough deflationary shock, however, could put a country into such a precarious state that it would be politically impossible to continue membership of EMU.

7 Expulsion or Voluntary Exit of a Country

The EU is somewhat reluctant to envisage this scenario except to refuse to deny the possibility. There is no proposal under the growth and stability pact to expel a delinquent country. But fines levied from bad countries and given to the good are like stealing from the poor and giving to the rich. A delinquent country seeing a large percentage of its GDP, up to 0.5%, going to countries that meet the criteria isn't likely to put up with this for long. It will dig in its heels. It will dare the powers in Frankfurt and Brussels to do something. Either they will relent and bail the country out, which is forbidden under the Treaty, or the naughty country will be expelled.

A country anticipating being expelled from EMU may make up its mind to leave anyway. Or, despite meeting the Maastricht criteria, it may decide it is unsuited to EMU, or that EMU is a mistake, and leave.

8 Mutual Agreement to Dissolve EMU

This would occur if EMU is proved to have been an empirically and intellectually experiment which didn't work and which brought more misery than it did prosperity.

A sudden exit from EMU, or even the real fear of it, could unleash chaos on the financial markets. The faultlines discussed in this article either on their own or combined together could well result in the monetary experiment falling apart. It is however, unlikely to occur overnight. It is only when those faultlines become the common currency of politicians facing an angry electorate that the real possibility of a mutual agreement to dissolve EMU would become a harsh reality.

HOUSE PRICES

*by Mr Stewart Robinson**

Gazumping, one of the uglier words in the English language, is enjoying a revival. Prospective homebuyers are having hopes dashed by counter-offers or by sellers withdrawing properties from the market in the hope of even higher prices in the future. Estate agents are smiling again, watching the queues of would-be purchasers. Houses are being sold at above asking prices even before the details are down on paper. House price inflation is running at 6 or 7 per cent and is rising. In London, the figure is more than 10 per cent, with particular areas experiencing annual rates of increase of 20 per cent or more.

We have been here before. At the start of 1987, the average price of a house in the UK was £40,000. Just two years later it had risen to £60,000. House price inflation across the whole country topped 30 per cent in early 1989.

At the peak the UK house market resembled a shark feeding frenzy. You were a fool not to get on the ladder. With parents reassuring us that we "cannot beat bricks and mortar", thousands became homeowners for the first time.

But then it all went horribly wrong.

House prices fell more or less continually between 1989 and 1995 and by 20 per cent in total. In London the figure was more than 30 per cent. Many of the first-time buyers saw the values of their properties halve and millions experienced the misery of negative equity.

One of the more remarkable features of the boom and bust has been that attitudes towards home-ownership have hardly changed. An Englishman's home is, apparently, still his castle. With this in mind, surely current circumstances should be setting alarm bells ringing. Is it happening again?

Well, no. The house market is enjoying good fortunes at present. And it is very different to the situation a decade ago.

When you look back at the 1980s, it is easy to see how overheated the house market had become. Over the past 45 years, both house prices and salaries have risen by 8 per cent a year on average. On three occasions, house prices rose decisively faster than incomes over a sustained period: 1972–73, 1978–79 and 1986–89. All were followed by a time when the house market – at least in terms of prices – performed poorly.

The worst, by far, was 1989–95. But that was simply because the previous

---

* Reproduced with kind permission of *The Times*. Stewart Robertson is a director of Lombard Street Research

excess had been so much more marked. Between 1953 and 1998, the ratio of house prices to incomes averaged 3.1. It reached an unprecedented 4.7 in 1989. In London and the South East, it exceeded 6. Today, the national ratio is 3.1, exactly in line with the historical average.

Granted, house prices are currently rising faster than incomes. But if incomes continue to grow at their present rate, house prices would have to rise by 10 per cent a year until 2006 for the same scale of imbalance to emerge. Moreover, there are three reasons for believing that the excesses of the 1980s – and therefore any subsequent slump – will be avoided this time.

First, the tax advantages of mortgage debt have all but disappeared. Much is made of today's "low" mortgage rates. But effective post-tax mortgage rates were lower in the 1970s and 1980s. The implication is that borrowers were foolish to worry about increasing mortgage debt. Indeed, the most rational approach was to maximise debt subject to the tax relief limits (which did not begin to bind until the late 1980s). Provided that house price inflation exceeded the effective mortgage rate – which it invariably did – net wealth rose. Tax relief on mortgage interest payments is pivotal in explaining the general buoyancy of the housing market in the 1970s and 1980s.

Secondly, the housing bubble in the second half of the 1980s was partly because of the large and rising number of first-time buyers. The key age bracket is those aged 20 to 39. The total number in that group rose, on average, by 50,000 a year in the 1960s, 100,000 a year in the 1970s and 150,000 a year in the 1980s. In the 1990s, the total has fallen, but only very slowly. However, between 2000 and 2009, it will drop by an average of almost 200,000 a year, a massive decline in the pool of potential homebuyers.

Finally, there is still a legacy from the previous boom-bust. The unprecedented fall in house prices led to a massive reduction in the value of the assets against which mortgages were granted. The ratio of total mortgage debt (ie, all our mortgages) to the value of the houses we own soared. It is still extremely high by the standards of the past 30 years. This ratio represents "capital gearing" and must be contrasted with today's low "income gearing" (ratio of annual mortgage payments to incomes). Which is the dominant influence? For most first-time buyers, it may well be the latter. And with low interest rates, perhaps high levels of debt are not as scary as they once were. But debt repayments from existing mortgage borrowers are a big offset. Just as the huge increases in borrowing in the 1970s and 1980s underpinned rapid house price inflation, so sluggish rates of overall debt growth today will restrain house prices.

One final point. If UK interest rates were to plummet to European levels, exceptionally low income-gearing would then provide a massive boost to the house market. In those circumstances, a serious – and unsustainable – housing boom would indeed be on the cards.

DEBT AND DELUSION
Central Bank Follies that Threaten Economic Disaster

by Peter Warburton
published by Penguin, February 1999, price £20

"Polo – the mint worth looking into!" is a slogan the manufacturer's advertising agency has not yet dared to use. The idea that there is a hole in the middle of the current phenomenal world economic boom seems similarly difficult to publicise.

But Peter Warburton, economic advisor to Robert Flemings & Co. has had the courage to take a very close look, found a build-up of unsustainable debt and concludes that in the near future defaults on a massive scale are likely; paper gains will be lost, and financial expectations – pensions, life assurance policies, dividends etc. will disappoint amid widespread capital losses.

The heart of the matter is a systemic lowering of risk premiums arising from vastly increased division of responsibilities in financial markets unsupervised by Central Banks. Thus Auntie's savings are placed in the hands of a financial advisor (who knows about taxes, a portfolio balance of income versus capital gain and has a reference book on financial 'products' but who has only a layman's knowledge of economics and no hand in actual investment decisions). This agent then hands the money to fund managers (who must aim at short term performance to retain league table position – at whatever overall risk is being taken by their competitors). The fund managers buy packages of bonds, shares and mortgages. The collators of these packages will obtain the price they need if they can secure a good enough risk rating. At the bottom of the heap loans have been made based on mechanistic assessments of borrowers' credit worthiness rather than by the old fashioned face-to-face method of character reference and project analysis. Thus barely honest 'Joe' gets a mortgage which he only intends to repay if he makes a capital gain on his property. This capital gain in all but the short term depends on inflation. But we live in a new world where inflation may not happen. When 'Joe' defaults, Auntie will lose her savings.

The process is supported by multiple complexities. The Derivatives market enables risk to be shared, spread and avoided. The free movement of capital across international boundaries makes control difficult. The development and increased sophistication of trading technology challenges effective observation and analysis.

Put another way, one could say that whereas in inflationary times, plentiful credit relative to investment opportunities would result in negative real interest rates, in non-inflationary conditions (brought about, in large part by Central Bank policies and in part by the East Asian crisis) a *proportion* of loans will end in default so that *average* returns will end up yielding negative rewards.

Or yet again, we could say that this is an extended re-run of the upswing in the "credit cycle theory"; an event supposedly banished by Central Bank regulation but on this occasion extended internationally to South Sea Bubble proportions.

When will this accumulation of debt collapse with disastrous consequences? How long have we got? Warburton concludes bluntly "Until the end of 1999? Probably. Until the end of 2001? Possibly. Until the end of 2003? That would take a miracle."

Thus this book offers a credible explanation for the "Long Boom" so unexpected by so many shrewd observers and predicts the manner of its end. Written during 1998 and published in February 1999 we need to ask what respected commentators have made of it. Is it convincing? Are we repeating the Japanese experience of the 1980s?

Under the heading "Deflation is a debt trap" David Smith (The Sunday Times, 14/2/99) describes the book as "analysis … at length" of anxieties he shares and concludes "we could all be counting the cost".

Under the heading "Oskar falls, capital rolls on" Larry Elliott (The Guardian, 15/3/99) comments "Mr Warburton's book is a devastating critique of the current financial system which he argues could lead to economic disaster on an unprecedented scale by the uncontrolled supply of credit and relentless buildup of debt" and quote after quote from the book is used to back the claim that we are blinding ourselves to logically forseeable problems ahead. Support again.

Under the heading "Gazing through a spyglass, darkly", Phillip Coggan (The Financial Times, 27/3/99) sets out the thesis, points to other authors who have made related points and then without challenging or contradicting the argument rather dismisses it all as the work of "prophets of gloom". No courage here to condemn or support.

Under the heading "The profits of boom and doom" Diane Coyle (The Independent, 4/3/99) comments "Logically, it could be right, but it is hard to know what odds to put on it". Diane Coyle is clearly worried and half convinced by Peter Warburton. She may well rearrange a small part of her finances as insurance in case he is right … but won't go all the way.

Under the heading "Taming global finance", The Economist (10/4/99), after acknowledging Warburton as a "respected economist and market watcher" counters his thesis by arguing that he "understates the extent to which governments, especially the American government, have moved towards fiscal prudence", he "mischaracterises derivatives", he "fails to explain that the conquering of inflation has brought about a fundamental shift in equity valuations" but nonetheless agrees that "today's financial system rests in part on shaky ground". So, a "could do better" and "the crisis will be put off a bit longer than you think" conclusion from The Economist.

Under the heading "Living on borrowed time" Robert Oakshott (The Spectator, 3/4/99) describes the book as "persuasive, important and brave". A whole page of explanation and choice quotes follows. Reading the book is recommended.

Bearing these reviews in mind I attended a seminar in which the author presented his case – a well attended seminar … Tim Congdon, Sir Sam Brittan … Warburton was received with considerable scepticism. He had "under-estimated the ability of financial innovation to overcome difficulties", he had "confused bonds with money" he had "exaggerated the risks with derivatives" he should accept that "Bond growth is natural in non-inflationary times". But no vote was taken and attendees had mostly yet to read the book.

Over a subsequent drink Tim Congdon gave me the impression that he was not taking the Warburton line too seriously and Russell Lewis felt that the analogy with Japan in the 1980s was wrong on the grounds that whilst Japan at that time made a load of dud investments, Britain and America are currently making profitable investments.

My overwhelming feeling is that this is a first-rate book that is educational and entertainingly written. Members *should* read it and we *must* take this discussion further.

THE RETURN OF DEPRESSION ECONOMICS

by Paul Krugman
Published by Penguin, June 1999, price £16.99

Written in February 1999, Paul Krugman appears to have read Peter Warburton's "Debt and Delusion" and then penned a lighter weight economic thriller moving ever more excitingly from chapter to chapter, on much the same subject.

As in Warburton's account he sees the western economies now playing out a larger and slower version of Japan's experience of the 1980s where Hedge funds, globally mobile capital and a credit pyramid threaten a 1929 scale crisis. We have, he says, recreated pre-1930s virtues but at the same time recreated old vulnerabilities. There is, therefore, the need to revisit the economic lessons and understanding propounded at that time – especially the central perceptions given by John Maynard Keynes.

But in supplementing Warburton's work he gives a more extended account of the unfolding Asian breakdown, a homely and easily understandable description of the economic principles at work and ends, not with recommendations for personal financial survival but with the lofty philosophical observation that "the only important structural obstacles to world prosperity are the obsolete doctrines that clutter the minds of men".

Krugman understands the need for negative interest rates to maintain full employment when nominal savings exceed nominal investment opportunities. Like Warburton he is unhappy at the idea of debt default as the mechanism to this end and concludes that on occasions governments (and especially the Japanese government at present) should announce inflation *targets* of perhaps 2% to 4% so that very low nominal interest rates can effectively achieve negative *real* interest rates. Krugman is notably much more gloomy than Warburton about current prospects for the Japanese economy.

But whereas Warburton sees the systemic underpricing of risk as leading to financial collapse, Krugman is more concerned that instability and timidity will result in depression levels of unemployment which in turn will undermine the world's commitment to free trade and our ability to help both poorer nations and poorer sections within richer nations.

Introducing (and in fact pretty well summarising) his book in a recent lecture at the London School of Economics; irrelevant, technical, scientific economic mumbo-jumbo seemed to fall away like smoke being cleared by a fresh wind as he applied Galbraithian oratory to economic meaning, and historical context to the issues – the really important issues – that now confront not just the economics profession but all of us as stakeholders in the productive world. He concluded his lecture by commenting that the economy is "ever scarier" because things are looking better at the moment. and warned of complacency because the sky didn't fall in last year. He added "it soon will". With the casual authority of an economic Terry Wogan, Krugman can convince and carry an audience (and his readers) so that in the end they know that they *can* understand, they *do* understand. And why didn't someone say it before?

J.B.

Editors note

Further reactions and comments from members on one or both of these books are welcome and every attempt will be made in the next issue to publish them.

CORRUPTION VERSUS DEMOCRACY

A comment from the Labour Euro-Safeguards Campaign

The general lessons to be learnt from the recent corruption scandals in the EU are not new ones. Perhaps the most obvious is that any organisation with wide powers, whose membership consists of a self selecting oligarchy, will always tend to become increasingly self serving. This certainly happened in the case of the Commission. The real problem with the EU, however, is that there is no countervailing authority to stop this occurring. The true bulwark against corruption is democracy – the power to vote out of office those who feather their own nests. In the EU, despite some democratic forms, the essential structure is bureaucratic and centralist – as its founders, who distrusted democracy, always intended it should be. Because the EU lacks genuine transnational political parties, it is very difficult to see how this will change. A sense of a political community extending across the whole of the EU simply does not exist. Almost everyone feels a stronger sense of affinity to his or her own nation than to any pan-EU political group. Until this changes, which could take a very long time indeed, if it ever does, the nation states of Europe would be ill advised to surrender their existing hard won democratic powers to run their affairs the way they want, and to set their own standards of probity and efficiency. Britain may not be perfect, but for hundreds of years we have never had anything equivalent in scale to the exhibition of corruption, fraud, nepotism and bad management which has recently been exposed in Brussels.

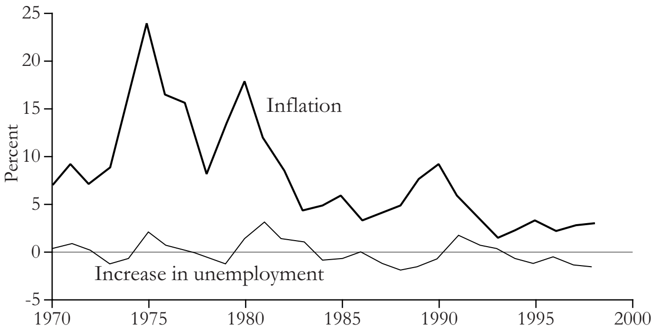
LETTERS

Inflation and unemployment – from Mr Henry Haslam

Sir,

In the Winter 1991 edition you printed a letter from me in which I looked at the relationship between inflation and unemployment for the period 1970–1992. My plot showed that a period of high inflation was followed by rising unemployment and, conversely, low inflation was followed by falling unemployment, contrary to the relationship predicted by the Phillips curve. My up-dated plot shows that this relationship has continued.

In my earlier letter, I speculated that the uncertainty that accompanies high inflation led to unreality in pay bargaining: when people expect or receive a higher level of pay than the market for their output will bear, the consequence is rising unemployment. As an alternative explanation, Bill Jamieson in *An Illustrated Guide to the British Economy* (Duckworth, 1998) attributes both the high inflation and the rising unemployment of the 1970s to an increase in money supply.



Whatever the cause of the relationship, I hope that we will hear no more talk of a trade-off between inflation and unemployment, or of unemployment being a price worth paying for low inflation. The record of the last 30 years is clear: policies that keep inflation down also help to reduce the level of unemployment.

Stanton Lodge Extension
Thurlby Lane
Stanton on the Wolds
Nottingham
NG12 5BS

"Endless" Credit! A further contribution from Mr T. B. Haran

Sir,

Perhaps I may be allowed to answer the wild assertions made by Mr Cheney in disputing in the Spring 1999 edition my *proven* contention that banks do NOT create money by lending.

He infers that I am not even half-educated in economics and finance, know nothing of bank accounting, play word games and do not understand insolvency. It appears that my credentials are in question!

For the record, I am a retired bank official. As such, I am fully conversant with-bank accounting, both domestic and international, and have lent the bank's surplus funds to the London money market overnight. Moreover, I have been head of an advances department and in that capacity represented the bank at creditors' meetings in respect of bankruptcies and liquidations. Mr Cheney certainly knows how to shoot himself in the foot, if nothing else!

I am sorry to have to rub it in, but my qualifications included passing an examination in economics. Nevertheless, I have always doubted the contention that banks create money by lending and set out to prove this matter, *one way or the other*, by tracing transactions which take place in the economy.

It is my belief that I have examined the issue in much greater depth than anyone else and was particularly well placed so to do. My findings are in stark contrast to current teaching.

We are either net service creditors (savers) or net service debtors (borrowers). The same principle applies to nations. Some, as is the USA at present, have to be net service debtors. That does not mean that the country is insolvent, as Mr Cheney maintains, for it could sell assets to clear the debts. It is extraordinary the faith he puts in statistics and in what everyone else, except Tom Haran, says!

You cannot compare his perspective with mine, owing to our views being based on different definitions of 'money'. His version, remember, is inadequate and dangerously unsound.

I do not agree with your contention that 'all credit is money and all money is credit'. They are two entirely different things. The amount of credit obtained by parties always equals that given up by others, so it is largely irrelevant. There can be no creation of credit in isolation; some other party always pays. Consequently, all versions of credit creation theory are misconceptions.

The laws of nature tell us that nothing can be created by lending. It follows that what comes into the banks (savings) goes back out when lent. Savings are intangible, but they can be transferred by titles to them such as cash and cheques. That is what happens when they are lent. The banks hold on to only eight per cent of them and pass on the rest by lending, spending and investment.

All payments are made with savings, owned or borrowed; indeed the economy is entirely financed by savings. There is no place therefore for credit creation theory.

Savings (basic money supply credits) can only be spent once and the results of that action accord with the status rules. The incoming funds going into creditor accounts are new savings; those going into debtor accounts are old savings spent on debtor services.

Deposits are not service credits (savings) or any form of money. They are simply records of to whom the banks owe them. That is why the banks, if called upon to repay their deposits in total, could only pay out a comparatively small percentage of them.

The destruction of credit creation theory means that the measures and broad money are also nonsense. Moreover, it should now be clear that the General Theory and monetarism are no longer credible. That really should make everyone stop and think out the issues for themselves.

My purpose in entitling my book, 'Bilateral Monetary Theory' is to disassociate my contentions entirely from the currently-accepted (unilateral) version.

Nevertheless, my findings may appear to add up to little more than an academic argument. After all, they will not change the way we use the monetary and banking systems.

They do however completely alter the perspective on how to manage the economy, to introduce sound practice, to eliminate unnecessary risk and to achieve a much better performance.

Bank lending is the key to managing the economy, for we get exactly the state of affairs it finances. Moreover, since the funds available for lending are a limited resource, borrowing for one purpose can crowd out another. We need therefore a much stronger management authority to run the economy in the national interest, to regulate bank lending and to use practical measures instead of theoretical ones to achieve-its ends. Here are some views on what it could do.

The interest rate policy is unsound. Raising the rates harmed the economy by destroying marginal businesses and causing a knock-on effect; subsequently lowering them could not repair the damage. In favourable circumstances, the growth rate was reduced from three per cent to nil. This policy should be discontinued and the Monetary Policy Committee disbanded. The new authority would eliminate inflation by instructing the banks not to finance remuneration increases.

Priority would be given to lending to business and industry and viable propositions would not be turned down through funds being lent elsewhere.

Lenders could be instructed to reduce the salary multiples for house purchase loans. Increasing them was intended to assist the buyers; the result was to create a sellers' market. Too large a part of the savings supply is being used in support of the housing market.

Foreign parties would not be allowed to take over British industry in circumstances where businesses and jobs could be relocated abroad; partnerships only would be allowed. The economy is not a global business; it is the sum total of local activities; that is why they must be defended individually.

Bilateral monetary theory allows us to note that there is no particular merit in savings, as borrowings have to increase in step. The authority would cancel the tax reliefs given to savers and investors.

It would instruct the banks to wind down *with extreme care* the funds lent in support of dealings of a gambling nature in currencies and investments. If such dealings go wrong, irredeemable losses can destroy part of the basic money supply (both credits and debts) and cause ever-decreasing knock-on effects, as happened with the Wall Street Crash of 1929. Care must be taken not to precipitate the danger. Nevertheless, it is completely unacceptable that depositors' savings should be put at risk in this way, particularly as the activity is unproductive and excessive salaries are being paid for managing it.

The decline in manufacturing must be halted and, with the assistance of bank lending, reversed. A country without an adequate industrial base is defenceless and, in any case, the present growth rate is far too low. We cannot improve education, spend more on health services or alleviate poverty without an increase in prosperity.

It should be obvious now that we must not, repeat not, join European Monetary Union. Greater, not lesser, control of our economic affairs is necessary and, in that light, no arguments in favour of joining are valid.

Summing up, the economy needs professional management on a much greater scale and at a much higher level of competence than we have ever seen before.

Grianan
23 Orchard Road
Bromley
Kent BR1 2PR

NEW MEMBERS

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

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

OBJECTS

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

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

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

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

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

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

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

BENEFITS

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

SUBSCRIPTION RATES

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

APPLICATION

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

APPLICATION FORM

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

Date ....

APPLICATION FOR MEMBERSHIP

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

This application is for
(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*) ....

SIGNATURE OF PROPOSER ....