BRITAIN & OVERSEAS

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

Summer 2000 Vol. 30, No. 2

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The articles published in this journal do not necessarily reflect the views of
The Economic Research Council

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

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IS THERE A NEW ECONOMY?

Extracts from a talk given by Professor John Kay to members of the Economic Research Council on Tuesday 28th March 2000

Economics is on trial

Just before I came out this evening I happened to look at the Arthur Andersen Web-site. Under a heading of "It's later than you think" a scene from H. G. Wells' classic book *The war of the Worlds* was recalled in which an English village awakes one day to discover that it has been invaded by decidedly unpleasant beings from Mars. Panic and confusion seize the villagers as the destructive intent of the newcomers becomes clear. 'All our work undone' one local cries out 'This must be the beginning of the end'.

Andersens then infer that new developments, like beings from Mars, are a totally different challenge and that all our work so far in understanding economics has been undone. 'Established organisations continue to make the assumptions and accept the constraints of traditional economics and traditional strategy, but today's electronic economy fuelled by a unique convergence of computing, communications and content technologies is subject to an entirely new set of rules' they say. In other words, everything I learnt as an undergraduate twenty-five years ago and everything that I've been teaching and advising people since then, has now been changed. We are living, it is said, in a New Economy, in which the old rules don't apply any more, where there are new principles of business economics and where the knowledge and learning that we have, is essentially irrelevant. So, has everything really changed?

An age of unprecedented technical progress?

Let us start with the claim made by people who talk about the New Economy that we are living in an age of unprecedented technical progress. Technical progress has been characteristic of the major western economies throughout the last two hundred (and in some respects five hundred) years but they claim that the discontinuity which we are now facing is of an order of magnitude different. It's bigger than railways, it's bigger than electricity, it's bigger than automobiles, it's bigger than aviation … they assert.

Which is not reflected in the statistics

Robert Solo, the great Nobel prize winning American economist said that 'computers seem to be everywhere except in the statistics'. In the twenty-five years from 1975 when computers started coming in until now, productivity growth in the United States has been about 2% a year – which is more or less exactly the rate which it has been throughout the last two hundred years. In the U.K. its been slightly lower than that.

But the statistics are misleading

However, the way in which we calculate growth and output and inflation, doesn't properly take into account the introduction of new goods and the improvement in the quality of existing goods. To take an example. Nathan Rothschild who in the 1830s was the richest man in the world, died despite the best medical attention all his wealth could buy, from an illness that today you could cure with antibiotics, which you can buy for a pound from any chemist. When we talk about that we are literally measuring the change in the cost of living. But actually the way in which the official statistics measure the cost of living doesn't pick up that particular benefit at all. We measure the value of medical treatment simply by what is spent on medical treatment. But clearly if the cost of treatment since 1930 has changed from the cost of the services of the finest (if useless) doctors to the cost of a few antibiotics, the price of the value for medical treatment has actually gone down.

Another example relates to the price of lighting, not just recently, but over the last three thousand years. Consider lighting from the days when people had to build fires in order to get light, to the time when they had candles to the century in which they had electric light. What we measure in our cost of living indices is not the price of light – it's the price of the things which you use to make light. Over the last two centuries the difference between the price of light and the price of the things which you use to make light averages 4% a year'

So there really is a problem here – we do in fact measure our economic statistics in ways that don't properly incorporate new goods and don't properly incorporate changes in the quality of goods.

Always – not just now for the New Economy

The trouble with the people who want to claim that this provides support for their arguments about the New Economy, that the figures are all wrong, is that they are right on this point but they have always been right and this has always been true for all the time that technical progress has taken place.

In the Rothschild case the real period in which growth was not properly measured was in the 1940s when antibiotics were introduced and on the lighting issue the point at which growth was really understated was at the end of the 19th Century when electricity was introduced into most people's homes. It has always been true that our productivity statistics, our measurement of economic growth, have underestimated the real growth of the economy. So to argue that the statistics fail to pick up the New Economy, is to argue not just that this is true but that this is much more true now than it has ever been in the past. And that is a much more difficult argument to put forward.

The need for a historical perspective

One of the most striking things about the New Economy debate is the degree to which people who talk about the New Economy actually lack historical perspective. If you go back sufficiently far in the past the only way in which I could deliver what I am talking to you about tonight was to actually come and talk to you (which is still probably the best way of doing it). Five centuries ago printing was introduced which enabled cheap communication to be available to everyone for the first time. A few centuries later you could send things down a wire. Rather more recently one could send printed copy over a wire by fax. Today I can actually communicate with you without there being any material record of what it is I say at all by doing it by e-mail. But it is quite difficult to argue that in these changes over the centuries, the last one is really the most transforming of these innovations rather than the earlier ones. And indeed I find it quite difficult to believe that these changes, revolutionary and important although they are, are really not just equivalent, but actually bigger than, the changes in economy, in culture, in politics and in lifestyles that came from the railways, from electricity, from automobiles and from aviation.

Recent progress seems over-concentrated on electronics

In 1965 the Hudson Institute on Advancing Technology produced a report giving a list of the innovations which they expected would occur by the end of the century. Now, it is interesting to see the things that have actually happened and the things that haven't. Everything that they anticipated in the area of electronics and information technology has come true. They were surprisingly prescient about it – they predicted faxes, they predicted mobile phones. They did's imagine we would have personal computers. They did rather think that we would have intelligent terminals in which we plugged in to some super computer, but you can kind of forgive them for getting that wrong. Basically what happened in electronics and information technology they very largely got right. But in every other area they over-estimated what was going to happen.

In the area of pharmacology for example, they anticipated that we would have drugs by the end of the century, that basically cleared out your veins and your arteries if you'd stuffed them up by going to too many dinners like this one' They anticipated that we would be far further ahead in having cancer cures than we do now. Since they were talking about personal space transport they would have been surprised to discover that we would fly around the world in the first decade of the twenty-first century in essentially the same aeroplanes as we flew around in in the 1960s. The first jumbo jet was produced in 1969 and that is still the largest form of passenger transport today. When they looked back at what had happened to fuel technologies between 1945 and 1965 they predicted the development of fuel cells and fusion methods of producing electricity to transform the ways in which we generate power. They would have been very surprised to know that the main way in which we get electricity in the first decade of the twenty-first century is by going back to burning coal and especially by burning gas. To take just one more example we can look at the complete transformation in the area of advanced materials that took place in the twenty years before 1965 when plastics, artificial fibres, new textiles and the like were introduced. Since then nothing much has happened.

So the economic data may be a good guide after all'

We should not be overwhelmed by the extraordinary pace of developments in one particular sector of the economy. So I suggest to you that what is happening in the productivity statistics and the economic data which in old-fashioned economics we are taught to rely on, is a better guide to what is going on than is endless anecdotes about advances which are going on in information technology.

The implications for share values

The valuation of technology shares certainly seems different now from earlier in my lifetime. How do people get to these kind of very high valuations? There is a phrase which sticks in my mind from Michael Lewis' account of Jim Clark, founder of three companies in silicon valley each of which have market capitalisations of several billion dollars. The key phrase in Jim Clark's presentation to the investors who have been buying shares in these companies is 'do the math'. Let me explain what the math is – I promise its not going to be very hard. There are basically two principles to the math – one is that a small fraction of a very large number is still quite a large number and the other is that if you start off with a small number it becomes a big number if it grows for long enough.

So if we take a dot com company, assume that in 20 years time it will have (say) a 5% market share and that its margins will be (say) 1% then we can calculate its revenues as so many millions in 20 years time and discount that back to a huge capital value today. And that is what happens when you 'do the math', and thus justify today's high share values.

But as well as doing the math, I think you actually have to do the 'econ' – as I was always trained to do. When a company operates in a competitive market, margins are forced down to something very close to the cost of actually doing the business. If you do the econ as well as doing the math I think you come up with very different answers and you start to understand what it is that has gone wrong with these kind of crazy valuations.

What has happened (and perhaps this is one of the main facts of the information technology revolution) is that people who found the (not very sophisticated) math a bit challenging when they did it at school, are now able to do these kind of calculations because they just have to press a few buttons on a computer, and a spreadsheet actually does it for them. But that doesn't make the answers very sensible or very meaningful.

So despite what is posted on the Anderson Consulting website, despite what the head of mergers and acquisitions at JP Morgan may be writing and despite proposed new principles of valuations I'm still inclined to take the view that the old basic principles of economics apply.

Bubbles – 'It's different this time'

The people who invested in the South Sea Bubble in the belief that International Trade was actually going to change the way in which business was done were absolutely right in the second part of the statement. The ways in which they got it wrong were in believing that by investing in that particular company they were going to make enormous amounts of money out of it. The truth is that all the innovations which I have described earlier, whether its printing, railways, electricity automobiles or aviation, which have all made huge differences to the economy and the way in which we live our lives, have been subject to economic competition which has ensured that the vast majority of these benefits have gone to consumers. Speculative bubbles are not new. There was the Japanese property and share bubble of the 1980s, the American bubble of the 1920s, the railway mania of the 1840s and the South Sea bubble of the 1720s and others. The extraordinary thing is the similarities in people's behaviour, the similarities in the things being said and the use of the four most expensive words in investment that 'It's different this time'.

EUROPE YES, EURO NO!

A talk given by Janet Bush, Director of New Europe, to members of the Economic Research Council on 17th May 2000

The debate about Britain's future in Europe and particularly about whether Britain should join the euro too often descends into unintelligent tribalism and yet there are many fundamental points on which most Britons would agree. There are three assumptions which should unite us.

The first is that we all want to promote peace in Europe. The founding fathers of the European Union were motivated by the highest ideals after two devastating World Wars centred on the European continent and this overriding aim remains. Speaking as the Director of New Europe, whose credo is summed up in the words Pro-EU Anti-Euro, I believe that, despite its evident shortcomings and an urgent need for reform and rethinking, the European Union remains the best vehicle to pursue peace and stability in Europe.

The second assumption that we surely share is that democracy is the political system that best represents the largest number of people. It is, in fact, an instinctive feeling that democracy must be defended that unites EMU-sceptics from left to right of the political spectrum in Britain.

The third assumption is that Britain should not join the euro unless it is clearly in the long-term interests of the British economy. This happens to be the Government's position so let us judge the question of whether the UK should join the euro first of all from a purely economic vantage point.

Despite continual, almost daily, speculation about the Government's intentions towards the euro, it repeatedly says that its policy has not changed since February, 1998, when the Chancellor laid out his Five Economic Tests to Parliament:

- Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
- If problems emerge is there sufficient flexibility to deal with them?
- Would joining EMU (Economic and Monetary Union) create better conditions for firms making long-term decisions to invest in Britain?
- What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
- In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

The Chancellor's five tests have been subject to widespread criticism. The conclusion of many commentators has been that the tests were drawn intentionally broadly in order to give the Government maximum discretion in making essentially a political judgement on when to hold a referendum on the euro.

Peter David, Political Editor of The Economist, took issue with the tests in his Bagehot column of September 25, 1999. He rejected the Chancellor's claim of clarity on the issue: "This clarity is an illusion, because none of the five conditions he has set for entry are the sort of thing which a normal person would understand by the word "test".

Mr David concludes that "the five economic conditions boil down to matters of judgement, which Mr Blair is free to withhold until he decides that the political conditions are propitious".

It is nevertheless worth taking the tests on their merits. The Treasury's own assessment in February, 1998, concluded: "Unless there is some profound change in circumstances in Britain and in the rest of Europe, it is likely to be some years before we can demonstrate that we have achieved sustainable convergence."

In my view, this remains the case. Indeed, the evidence shows that, if anything, the economies of Britain and Euroland have diverged even further since January, 1999.

There is continuing divergence on macroeconomic indicators such as prices, growth and interest rates, not just between Britain and Euroland but also between those economies that already make up the eurozone. Inflation rates are now marginally further apart than-when the euro was launched, as are estimated output gaps. Interest rates have moved closer together but it is highly uncertain whether the gap will continue to close or whether it will widen out again. In any case, even an interest rate differential of 2.5 per cent currently is large enough to cause problems if Britain were to join the euro, as Eddie George, Governor of the Bank of England said in April.

The Governor's overall judgement was that the British economy and the Euroland economy "continue to diverge", a view supported by the IMF as well as the European Commission.

The level of the exchange rate, probably the most crucial factor determining the performance of an economy, is not mentioned in the Chancellor's five tests. However, the depreciation of the euro against the pound has become the single most potent indicator of divergence between Britain and the eurozone and therefore the most intractable hurdle to early membership of the single currency zone.

Wim Duisenberg, President of the European Central Bank, said in January 20OO that convergence between the UK and eurozone economies was "years" away. He also made it clear that it would not be acceptable for Britain to manipulate the exchange rate lower in order to join the euro at a more competitive rate, making a nonsense of current calls on the Government "to do something" to weaken the pound and so join the euro.

There are other deep, structural differences between the British economy and many of those in Euroland. Safe entry into the eurozone would need harmonisation of structural and even behavioural economic characteristics. For example, around three quarters of mortgage debt in the UK is at variable rates, compared with only 5 per cent in France and Germany.

Another large difference is that Britain has more than £750 billion invested in private pensions, more than the rest of the EU put together. Germany has only £179 billion and France £57 billion invested respectively. Funding provision for future pensions differs hugely between different EU countries with enormous implications for budgets. A recent study by Niall

Ferguson and Laurence Kotlikoff estimated that, to fund future pensions liabilities, Austria would have to raise income tax by 55 per cent, France by 64 per cent, Germany by 29 per cent, Spain by 45 per cent and Italy by 28 per cent.

Ireland, by contrast, could cut its income taxes by nearly 5 per cent and still meet its obligations – all in a single currency area!

The problem of lack of convergence between Britain and Euroland is then compounded by a divergence in the economies of the eurozone itself. Within monetary union, Euroland has a single interest rate but the growth rates of different economies are diverging, making it more difficult to live with a one-size-fits-all monetary policy.

Testing for the potential impact of euro-entry or euro-abstention on investment and the City is difficult because nobody know for sure whether these measures would have improved if Britain had joined the euro. All we can say is that, since the euro was launched without Britain, investment has hit new records and the City has thrived. In December, 1999, Bank of England figures showed that London's share of the euro-denominated bond markets had grown from 48 per cent to 58 per cent between the first and third quarters of the year. London's share of the derivatives market for euros is 94 per cent.

The jobs test does not work in favour of early euro entry either. Pro-euro trade unions warned that one million British jobs were in danger because Britain had not joined the euro at its launch. However? Britain has continued to create jobs. On the International Labour Organisation measure, the British unemployment rate has fallen from 6.2 per cent in March, 1999, to 5.9 per cent in January, 2000. Euroland unemployment has also fallen over the period, but from a much higher base. In March, 1999, its ILO rate was 10.2 per cent, falling to 9.5 per cent in January 2000.

The flexibility test is no nearer to being met. Being part of Economic and Monetary Union means that there is little or no flexibility to use the traditional tools of economic policy to either float any single economy out of recession or to put the brakes on an inflationary boom. Every EMU economy lives with the same exchange rate and interest rate as others, despite differences in economic performance. The Growth and Stability Pact also imposes a uniform limit on the use of fiscal policy (taxes and public spending) to regulate growth.

This means that flexibility has to be found in other ways. The main, generally recognised tools of flexibility are labour migration from low unemployment to high unemployment areas; the ability for wages to rise and fall easily in response to economic shocks through the removal of high taxes and rigidities in labour markets; or fiscal transfers from rich regions to poor regions.

The first two tools do not, at present, provide enough flexibility to counteract the new rigidity in macroeconomic policy. Labour mobility within the EU has risen slightly but is still far lower than in America where there has long been a culture, aided by a single language, to up-sticks and move to where the work is. Progress in making labour markets work more flexibly has been unimpressive. Otmar Issing, Chief Economist of the European Central Bank, said (March 2000) that the lack of reform in the eurozone posed "an almost lethal threat to monetary union".

Fiscal transfers – the third safety valve – are not available to the extent needed to cure imbalances between eurozone economies. At present, the EU central budget only accounts for 1.2 per cent of EU gross domestic product.

Addressing this problem would involve a significant new commitment to increase the central budget of the EU which may prove very difficult at a time of significant budget restraint in the eurozone. It would also involve a political acceptance by taxpayers in different European countries that their taxes may have to be spent, to a far greater degree than now, on other countries that have run into economic difficulties.

The reality is that) in order to inject a needed flexibility into the eurozone economy and so ensure that the single currency is workable in the long-term, a far larger centralised European budget would be needed. This would mean that not only control over monetary policy- interest rates and the exchange rate – but also fiscal policy – taxation and public spending – would move from national parliaments to a centralised European "economic government".

This is why the European Central Bank and EU member states particularly France and Germany – have been talking about a fully-fledged Federal State. Wim Duisenberg, President of the European Central Bank, has stated: "The process of monetary union goes hand, must go hand in hand, with political integration and ultimately political union. EMU is, and always was meant to be, a stepping stone on the way to a united Europe." Dr Otmar Issing, Chief Economist at the ECB, has said: "There is no example in history of a lasting monetary union that was not linked to one state."

In May, France and Germany put the federalist agenda back at the heart of EU politics. Laurent Fabius, France's Finance Minister, urged the creation of a European economic government to buttress the falling euro. He said that France would use its presidency of the EU in the second half of this year to push for closer co-ordination of economic, fiscal and tax policy. Joschka Fischer, Germany's Foreign Minister, was even more explicit. Within the last week, he has called for a "transition from a union of states to full parliamentarisation as a European Federation. That means nothing less than a European parliament and a European government that really do exercise legislative and executive power".

This brings me back to my starting assumption about democracy. There are intractable political problems on the road to political union, not least that an overriding sense of European solidarity does not yet exist that would make a central state work. People are sensitive enough about a penny on income tax in their domestic economies without being told that higher taxes are necessary to bail out farmers in France or pensioners in Portugal.

But a far greater problem than a natural bias towards self-interests on the level of the nation state is that the institutions are currently not in place to ensure that a single European government, with a great degree of pooled sovereignty, is genuinely democratic.

Bernard Moss, Associate at the Institute of European Studies in London, has put it well. "The EU does not possess the constitutional and institutional foundations for economic government. It lacks the democratic legitimacy and accountability before a European people or demos to assume such a role. Policy divergence among members, particularly France and Germany, caused by disillusionment with monetarism, make agreement on macroeconomic policies extremely problematic. Finally, states may have reached the limit of their transfer of sovereignty without losing their coherence as constituting bodies for their society."

He goes on to argue that "most of the Europeans who identify with the EU see it as an aid to the nation state and not its replacement".

If, as I suggest, the economic strains within the single currency area increase, genuine democracy is needed to act as a safety valve for discontent and genuine democracy simply doesn't exist at the supra-national level of the EU.

This brings me to my first assumption: that we all want peace in Europe. This is why, despite a strong sense of disillusionment with the EU, the majority of British voters still want to stay in the Union. However, it is now questionable whether the federalist model is the best one to promote peace and stability.

It is clear to me that there economic tensions will rise within the eurozone if imbalances start to build up with no economic safety valve. Economic discontent could soon turn to political discontent. At a time of too little pan-European democracy, there is no sufficient political safety valve in place. The risk is that ordinary people replace their current apathy about the EU to out and out mistrust and disapproval.

Robin Guthrie, former Director of Economic and Social Affairs at the Council of Europe, believes that such hostility could put the whole European project at risk. In his pamphlet for New Europe *The Good European's Dilemma,* he offers a deeply serious critique of the centralising agenda which he believes is dividing, not uniting, Europe.

The obsession with federalism with EMU at its centre is a real threat to the enlargement of the EU to include those countries which broke free from Communism in 1989 when the Berlin Wall fell.

The risk to peace no longer comes from Germany but is, if recent history is anything to go by, more likely to come from central and eastern Europe. The best strategy to promote democracy and indeed prosperity, so crucial to lasting political stability, is to enlarge the Union.

And yet the evident problems of EMU are putting the programme of enlargement back. "Enlargement has, in effect, been turned from an exercise in pan-European unity to an empire-building process as though the west had been victor in the long cold war of 1945–1989 and central Europe a defeated enemy," Robin Guthrie writes.

Discontent and dismay is rising in those countries of central and eastern Europe which want to join the EU but fear that their chances are receding. The President of Poland recently accused the EU of a "virus of selfishness" and said that delays to enlargement were now casting doubt on whether it would be pursued at all and warned that the consequences would be a rise in nationalism and anti-European extremism.

At the centre of the arguments proposed by advocates for the euro is a moral certainty that only by integrating Europe, both politically and economically, will peace be assured. I believe there is a strong case that suggests the precise opposite. That is why so many thoughtful people, from left to right, who support the European project are also so deeply opposed to the euro and the federalist agenda of which it is a key part. (It is worth noting that prominent British euro-advocates do not actually admit this link, astonishing given that the relationship between EMU and political union has been explicit and publicly discussed in continental Europe for many, many years).

The case for EMU, I believe, fails on all the three assumptions that I have outlined. Of the three, democracy is probably the most profound, instinctive worry of those opposed to EMU in Britain. If the debacles of devolvement to the Welsh Assembly and to the London Mayor tell us anything, it is that people do not like being dictated to by imperious governments. People like democracy. They like kicking politicians out if they don't rate them. This is true on the scale of the nation state but even more so if a single political government of Europe is in prospect, undemocratic and remote from ordinary people.

In Britain, those who campaign for the euro are so dominated by their fear of the xenophobic right that they are prepared to go unquestioningly into a Federal Europe with no regard to the economic or political realities or to the democratic instincts of a majority of British voters.

I met recently with Hugo Young, the eminent political columnist of The Guardian, and tried to explain that there are reasonable people who are deeply pro-European who argue against this project on the grounds that it will be bad for Europe. Days later, he wrote in his column in the Guardian that there were only two ways to persuade the British people to be more pro-European: seduction and fear. He concluded that only fear would work and suggested that on the day of judgement, "terror should stalk the land".

I do not believe that voters would respond to "terror" in the form of a Government pro-euro campaign that deliberately scared them into believing that, outside the single currency, their jobs, pensions, mortgages and livelihoods would be at risk. But I think we would all do well to be prepared for a campaign which trades on people's natural insecurities and which bypasses rational discussion not only of the economic arguments but also of the political agenda now actively being pursued on the continent.

PRIVATISING BRITISH UNIVERSITIES*

By Mr Wai Wing Li

Today, one in three school leavers go to university. In 1986, when Kenneth Baker was appointed Secretary of State for Education, the figure was one in eight.

Mr Baker transformed the way universities were financed. Previously, universities were getting most of their money from block grants from central government, with student fees paid by local educational authorities (LEAs) making up a small proportion. Mr Baker reduced the block grants and raised the fees, introducing a system where money follows the students. Student numbers has more than doubled; the number of young people in higher education has risen from 550,000 in 1986 to over one million today. However, the Treasury soon realised that although students were being educated more cheaply, the rise in the number of them sent the total cost soaring. Fees paid by LEAs were repeatedly cut and in 1992, the government decided to put a cap on expansion. Overall, government funding rose much slower than the increase in enrolment, and university funding per student has plummeted to £4718 in 1997/98, a fall of 21% from 1986 levels.

In addition, vice-chancellors calculate that there is a building maintenance backlog of £2.5 billion. One university has some laboratories that are 50 years old, and it is spending only half the annual amount needed to update them. Zoology research at another university may have to cease because the animal houses are in danger of collapse.

The universities have sought out other ways of gathering income. These consist of depressing academic pay, students paying hidden charges, commercial operations, corporate sponsorship, and recruiting more overseas students.

Average academic salaries have risen in real terms by around 10% in the past decade, compared with a national non-manual average of about 40%. A senior professor could be earning less than £40,000 a year. Workload has greatly increased with the rise in student numbers. A survey by the Association of University Teachers found that academics are working a 53-hour week even in vacations. Universities are losing staff and they face a losing fight against industry in the battle for talent. The Guardian

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* This is the winning article of the Summer 2000 Economic Research Council's Compertition. Mr Wai Wing Li is an undergraduate at the London School of Economics.

newspaper recently commissioned a poll on teachers' job quality, and found that just over half the university lecturers expected to leave the profession within 10 years and 72% within 15 years – although this was similar to the proportions of schoolteachers expecting to quit, the lecturers were more likely to cite poor pay as a reason. We are seeing a drying up of the supply of academics, as home students increasingly shun PhD studentships in favour of Masters Degrees, with their sights set on finance jobs in the private sector.

Students are having to buy more of their own books and materials. One college estimate that these hidden costs add up to £200 per school term, with art and design students being asked to spend far more than that on paints and materials. Going further, the Department for Education and Employment proposes to allow universities to charge extra fees for "non-core provision": study packs, extra materials, and access to library and Internet services etc.

Extra revenue have come from running summer schools, offering conference facilities and renting out halls of residence for tourists. Many have started merchandising branded products such as T-shirts and umbrellas. Annual sales of Oxford University goods exceed £4 million, with three-quarters of its sales going to South East Asia and Japan. Warwick University wholly runs a commercial printing business, bookshop, hair salon, newsagents, post office, gift shop and a general store.

Universities also need to gather sponsorship from industry and commerce: an Oxford University department was renamed Kellogg College after receiving a gift of £4.7 million. There has been a rapid rise in the number of overseas students, who pay up to £9,500 per year for undergraduate courses at some universities, compared to about £1,500 from home students.

Although these sources of funds improve a university's finances considerably, government funding still on average account for two thirds of universities' income. Universities are reaching a limit as to how much they can increase working hours, earn from corporate sponsorship, merchandising and so on. They are largely dependent on government funds, but a large cash injection of funds is needed just to off-set previous years' budget cuts, paying for buildings maintenance and much-needed increases in staff salaries etc.

Although higher education spending totals £8 billion in 2000, just 2.2% of total government expenditures, much lower than the average of other

OECD countries; more cash from central government is very unlikely. In today's political climate, it is no longer feasible to return to a policy of 'tax and spend'; furthermore, among education spending, many voters would consider primary and secondary schools more important. After all, Mr Blunkett constantly reminds us that on average graduates earn 20% more than others. Extra funding in the future is unlikely to come from the government, especially if the economy worsens.

With universities unable and government unwilling to raise funds, the burden of costs fall on the students and their families. In 1998, a means-tested student loan partly replaced the maintenance grant; and in 1999, the grant was fully replaced by the loan. This abolition of maintenance grants is against the wishes of the Dearing review. However, though this is expected to release £1.7 billion by 2017 when the loans are repaid, the Treasury receives no immediate benefit; and the universities do not get any more funds except a £165 million boost produced by paying loans termly instead of monthly. The Treasury could utilise its veteran skill of redefining expenditures to exclude repayable loans from public expenditure, as the Netherlands and Australia have done. This would release considerable resources into the universities. However it has been reluctant to do this and is unlikely to do so in the future.

Already, the poorest students leaving a three-year undergraduate course in London will be indebted to the government by around £13,000. In many cases it will be higher, as some will have taken out the £250 hardship loans from the government, as well as loans with the commercial banks and relatives. Currently, only 10% of UK students starting full-time degree programmes come from social classes IV and V, compared with more than 60% from social classes I and II. This composition of the student body has hardly changed with the expansion during the past decade and a half.

The Dearing report states that "The aim of expanding access to higher education is to give more opportunity to the bright sons and daughters of manual workers, not to admit the less able children of the middle class".

As well as meeting current demands for funds such as higher staff wages and student facilities, British universities require more funds to improve resources for research and teaching infrastructure such as library and IT facilities, in order to compete with the best in the world. Some steps to do this could be raising the maximum amount of loan students can borrow, and the deregulation of fees, allowing the most popular universities to charge higher fees and for others to attract students by cutting fees. This will have to be backed up by a government scholarship scheme to ensure that merit alone determines admission. There will also be additional support from universities. Cambridge University already provides bursary funds of up to £2000, aided by endowments, alumni contributions, charities and companies. Students from higher income families will have to pay more, but is it not only fair that parents who have paid several thousand pounds per year sending their children to private schools pay more than others for university?

It is clear that many students from the lower and middle classes, as they are unable to get the scholarships, are having to pay more – or choose a less reputable university. However poorer students are already disadvantaged by not being able to go to private schools, buy better equipment (eg expensive graphic calculators), private tuition and even home access to a computer. One could argue that fairness can only go so far.

Instead, introducing market mechanisms into the higher education is likely to make the allocation of a scarce resource (student places) more efficient. At present, especially with the introduction of the student loan, demand has sharply risen for the more reputable universities. Anecdotal evidence from the London School of Economics shows that in some departments, the ratio of application to places has roughly doubled from 10:1 to 20:1. How can admissions tutors identify the best student with the most potential in these cases? As one admissions tutor confesses, "It can be like a lottery". By introducing fees, governments would no longer have to worry about how many 18- year-olds should have the opportunity of higher education, nor about which subjects should be supported. Some argue that education at an university is to pursue a subject in depth, not to provide a qualification for a job. Students would be weighing the cost of fees and living expenses, against higher future expected earnings and the opportunity cost such as forgone wages if instead of going university, they take up employment. If students had to contribute to the cost of their courses, decisions about the size of the university system would be left to them.

One of the problems with these proposals is that universities such as those in the Russell group have much to gain through charging as much as they want and take as many students as they like; whilst at the other end of the market, the further education colleges and access-oriented former polytechnics will struggle to fill student places and they will have find ways to cut costs and offer discounts. This reinforces the divide in higher education, but it may not be a bad thing. The less reputable universities will try harder to gain higher research ratings and provide better facilities, to climb up the university league table. Those that fail to do so may have to close, but some would argue that this is more desirable – to convert these university buildings into business offices, government offices or public libraries, instead of churning out graduates with worthless degrees from unpopular universities.

Another problem is that the government is still having to initially pay out more money, increasing its expenditure; so if this is not possible then any changes may have to wait until the student loan repayments to the government start to add up to a considerable sum, which will be several years off.

There are precedents for universities to charge full fees both abroad and at home. British universities are not constrained by legislation on postgraduate degrees, and different tuition fees are being levied. Warwick University, for example, charges its home students over £4,000 to study for Masters Degrees.

Funding for higher education has to come from somewhere, with universities unable to raise the considerable sums on their own and a government keen to control public spending, the burden has to fall on the students. Although it is true that society gains from having more inventors and entrepreneurs in the future, the main beneficiaries of university education are the students themselves. The student loan fully replaced the maintenance grant last year, yet that has not stopped nearly a third of 18-year-olds going to university.

With universities charging differential fees, it is only one more step to privatisation. Privatised universities will be able to borrow on their assets, merge with each other, run along corporate lines and operate independently of the government. Some universities with a lower reputation and less assets than the others may have to close; others will be forced to specialize: already, we have seen that Bath University has had to run down its large and successful horticulture department, disposing of acres of greenhouses, because it was out of place among biological sciences that were increasingly molecular in emphasis. Many can only survive by becoming a "niche provider" of a small number of courses.

Professor Andrew Oswald argued in a recent letter to the Financial Times, "Let us announce that from the year 2015, each British university will become a charity whose capital stock is the property of all of its past students still alive, that there will be a guaranteed level of public funding until then, but that after 2015 all public money except some scholarships and research grants will cease; and that from 2010 all universities can do whatever they wish (including charging fees) to cope with the cut-off point 5 years later" "This horizon would allow parents a decade to make sensible plans".

There is some merit in this argument. It is similar to what has happened in Australia. In 1996, soon after it came to office, the Howard Liberal government slashed more than $600 million, or the equivalent of 30,000 student places, from the higher education budget – the largest cuts in history. As well, universities were permitted to allocate up to 25 per cent of their places to students paying full up front fees. The funding cuts resulted in thousands of academics' jobs being shed, courses closed, and students being forced to take out much larger loans to finance their own education under the Higher Education Contribution Scheme. One important point is that the closure (or contraction) of some unpopular universities does not hurt but benefit students, if this is accompanied by expansion of the more popular universities. This is an approach that Mr Blunkett could consider, though probably with a longer transition period.

With the ever-increasing need for funds, dictated not by the chancellors but by a global market demanding ever higher standards of research, differential fees is a promising solution to maintain British universities at its currently high standing in the world educational market. It is likely to go ahead after the next general election, despite protests from student groups.

However, it is important to ensure adequate government funding for poorer students in the form of scholarships; in order to ensure that the real impact of the funding changes is not to reverse the improvements made in the past 20 years, and return higher education to its former role of being only for those from relatively affluent and educated family backgrounds.

I can see the deregulation of fees occurring within the next 10 years, with the privatisation of the universities taking place in the following 10 years. I see the British higher education system converging to the present American model, where there is a high degree of competition within a market setting, but with a higher level of state intervention. UK universities do not have the multi- billion dollar endowments and alumni contributions associated with top Ivy League institutions, so the most likely model would be those found in states like Michigan and California, where they tolerate differential fees between universities, but there is a significant state contribution. Most importantly, these reforms mean that universities will finally have access to much-needed funds.

EXPLAINING JAPAN'S PLIGHT

No doubt reports of Japan's economic death are 'greatly exaggerated'. Given that country's proven ability to amaze the world, it is the eagerness of foreigners to analyse, explain and prescribe remedies which is perhaps the more newsworthy story. Is a clear picture emerging at last?

A good reference point is the magnificent seminal work by the Brookings Institution published in the book edited by Hugh Patrick and Henry Rosovsky *Asia's New Giant* in 1976. This highly authoritative book, analysing every conceivable facet of Japan's economic performance arrived just at the moment when Japan's growth rate plunged prior to hobbling along at a low rate during the 1980s and collapse entirely during the 1990s, but managed to conclude that Japan "may well … sustain a markedly superior economic performance for some time to come".

With the benefit of hindsight can we now see where those authors went wrong in 1976? In Japan, outsiders are easily mislead. 'Tatemae' (the version you would like another to see or which you think should be the case, even when reality is otherwise) befogs even the most cynical observer. America's Brookings Institution gained little appreciation of the 'pork barrel!' corruption of the Tanaka administration and had no feel for any prediction of future trends in political pay-offs. The book made only light criticism of Japan's Fair Trade Commission, almost totally failing to sense the importance of that body's inability to promote normal competition. Hidden restrictive practices and especially the informal work of industry associations are barely mentioned and most certainly denied their true weight in assessing Japan's performance and her resistance to imports, foreign workers and inward direct investment. In short, even the most sophisticated foreign observers of Japan in the 1970s subscribed to the idea that the known weaknesses of corporatist economic management somehow did not apply to Japan.

The latest British contribution falls for the same trap. Keith Cowling and Phillip Tomlinson, writing in the latest edition of the *Economic Journal* claim that Japan's demise has less to do with its domestic economic model than with global over-expansion. If only, they say, Japan's cash rich large corporations would invest at home rather than abroad, 'hollowing out' with the consequent loss of jobs by subcontractors, would have been avoided and all would be well. Wrong again. As Bill Jamieson commented (Sunday Telegraph 25/6/00) such 'lost' investment could normally be expected to be balanced by domestic (mostly smaller) firm's investments and by inward investment from the 'globalisation' efforts of larger firms from elsewhere, but this has been hampered by corporatist regulations, politics and restrictions.

For those who need some guidance on literature that is getting much closer to the mark three works can now be recommended. The most outstanding analysis came from Richard Katz in his 1998 book *Japan, The System that Soured*. Japan has one key – and chronic cultural weakness. This is the inclination to collude whenever possible for the purpose of reducing uncertainty and confrontation. This operates at every level, from harmless day-to- day social customs to long term government-industry arrangements. Such cosy avoidance of tension worked in favour of increased investment and growth during the 'developmental' stage between 1945 and 1970 but has increasingly hobbled initiators of change and progress under conditions of economic maturity. Japan's big firms resemble something like wealthy medieval monasteries (needing to face Henry VIII's dissolution) or cossetted Nationalised Industries (needing Margaret Thatcher's privatisation programme).

For those who would wish to back up Katz's analysis one can commend Lonny E. Carlile and Mark C. Tilton (Eds) *Is Japan Really Changing Its Ways? – Regulatory reform and the Japanese Economy* (Brookings 1998) and Ivan P. Hall *Cartels of the Mind* (Norton 1998).

Two years on from these three publications, their analysis looks increasingly well justified. Bill Jamieson speaks of "an irregular wheezing and sputtering that passes for recovery". Prime Minister Mori simply does not hold out the promise of regulatory reform that seemed possible under Prime Minister Obuchi.

J.B.

BANKER TO THE POOR

The autobiography of Muhammad Yunus.
Published by Aurum press 1999 Price £9.99

This book is a rare treat. Let this reviewer begin by joining H.R.H. The Prince of Wales (who contributed the Foreword) in commending it to you.

Professor Yunus, Head of the Economics Department of Chittagong University, decided to try and help poverty stricken fellow Bangladeshis. He soon realised that in the villages there were many women (and a smaller number of men) who were doing useful work at home but who could not make the most of their work because they were unable to borrow the small sums needed to finance this and because no-one seemed to trust in their abilities. So he created the Grameen (which means 'village') Bank. Women who can benefit from tiny loans are brought together in a 'support group'. At first, and still generally today quite tiny sums are lent them (hence the term 'micro-banking') against which no collateral whatsoever is asked. Credit means 'trust' and by showing confidence in people and financing simple self employment, lives are transformed. The bank has expanded, members now number millions and repayment rates are over 98%.

Which is in stark contrast to the official banks in Bangladesh with their repayment rate record of 10%'

Today, schemes based on Grameen principles operate in some 60 countries – including the U.S., Canada, France and Norway. It is by no means limited to the conditions of Bangladesh. And the enterprising Professor has expanded into other enterprises from fish farming to cellular telephones; from Internet service provision to research on solar and wind energy – and from education services to portfolio management. It seems not unfair to suggest that, in order to grasp the kind of person we are dealing with, we regard him as Bangladesh's answer to Richard Branson' Here is a dynamo who can think through problems from first principles, cut through conventions and social obstacles, motivate others to help him and who personifies the qualities needed to market his ideas.

So most certainly, a part of the success is due to this particular character. But it would not be right to argue that others cannot follow in his path or that the ideas involved do not have a wider application. On the contrary, he is right to criticise conventional banking for its lending policies. He is right to criticise conventional economics for forever talking about 'firms' and 'numbers of employed workers' rather than about that troublesome element, the 'self-employed'. And he is right (but by no means the first) to criticise international aid on the grounds that it lines the pockets of the rich and undermines the poor. And he is right to point out the harmful madness of education systems which prepare young people only to be employees and never to be self-employed entrepreneurs.

But there is much more. Case examples, anecdotes and personal experiences. Insights and knowledge of people, continents and institutions explained in simple clear terms. Chapters read like a series of emotional explosions and Price Charles is fully justified in saying "I know that it will fascinate and entertain". It will also educate.

J. B.

LETTERS

The differences between purchasing power and money. A response from Mr T. B. Haran to Mr Alan Shipman's letter regarding unemployment and inflation, and to the History of Credit and Specialisation in the Understanding of Economics by Mr Christopher Meakin

Sir,

Mr Alan Shipman added a P.S. to his letter in the Autumn 1999 edition, which reads:

> In the light of Mr T. B. Haran's assertion that "banks do not create money by lending" (Endless Credit B & O Summer 1999) would you ask him to explain the East Asian debt deflation of 1997-8?

Let me so do. The economics profession has failed to make a very important distinction ie. the differences between purchasing power and money. Consider the facts. People trade solely in services, whether their work is productive or otherwise, and goods are a by-product of that system. Some people have contributed more in services than they have obtained and own purchasing power in services to the extent of the difference; the rest have obtained more services than they have contributed. The former are service creditors, the latter service debtors.

Purchasing power is intangible and has to be represented by temporary titles to it, such as cash and bank deposits. Money is the unit of account by which the outstanding services are measured and made exchangeable.

The properties, however, of the thing being measured cannot be transferred to the unit of account. Thus, a therm cannot become gas and money can never be more than a measure and a medium of exchange. It is *not* a store of value; credits in services perform that function.

So-called monetary crises suffered by nations are misnamed. They are not of a monetary nature and stem from the inability of the nations concerned to perform the services needed to earn the money to repay their debts. Thus, the reflection of these trading problems in monetary terms is simply the mirror image and not the substance. That is the answer to Mr Shipman's question.

The quantity of therms is rigidly controlled by the amount of gas. In the same way, the quantity of money is similarly restricted by the amount of credits in services not yet spent. As proved in my books, 'The Monetary Analysis' and 'Bilateral Monetary Theory', total service credits always equal total service debts.

Banks do not create money by lending; they lend existing service credits. The creation and destruction of purchasing power can only be caused by trading activity and that is not involved in bank lending. Thus, a banker cannot change the quantity of purchasing power by making entries in his books as that does not alter the amount of service credits.

Nevertheless, none of this should detract from the tremendous importance of bank lending. That, however, is because the state of economic affairs is largely due to what has been financed and has nothing whatever to do with the mythical notion that banks can create money by lending.

To date, I have sought to have my views accepted purely on their own merits, but I have to concede that they have largely been ignored. The time has come, therefore, to point out that there is no way in which credit creation theory and monetarism can possibly be correct. Both are fatally flawed by seeking to transfer the properties of the thing being measured (service credit) to the unit of account (money).

Great advances have been made in the ways in which we trade with one another and a higher standard of living is one result. On that score, I would like to congratulate Mr Christopher Meakin on his excellent coverage of the history of credit summarised in the Winter 1999 edition. I would, however, disagree with his contention that there is no limit on the capacity of the banks to create loans. The lending cannot exceed the total of the outstanding service credits or, in other words, the purchasing power.

As long as the lending is sound and repayments are made as agreed, the system ticks over and gives the impression that credit is endless. Bad debts, however, as demonstrated by the aftermath of the Wall Street Crash, can reduce the purchasing power in a community, as they destroy an equal amount of service credits and service debts. The previous level of bank lending cannot be maintained and the standard of living has to fall.

It is interesting to note that all the advances covered by Mr Meakin are practical achievements and are strictly confined within the parameters of trade. Note, therefore, that the economy is a practical issue and should not be subjected to theoretical experiments, such as the interest rate policy. Trade must be encouraged and not hampered. Extra business results in an equal increase in service credits and service debts and is not a cause of inflation. That undesirable condition arises when banks grant loans to cover remuneration increases and the employers recoup the cost by raising prices. It is damaging because it alters the terms of trade and cheats the service creditors.

Consider carefully the differences between purchasing power and money, as no progress can be made in economic thinking until they are recognised and accepted.

The tribal system took care of all its people, but the monetary one excludes those unable to engage in trading activities for whatever reason. Some form of support is therefore necessary. Ideally, everyone should have a basic income from birth and throughout life, which is at least adequate to live on. Accordingly, that is the direction economic thinking should be taking instead of being bogged down in false theory.

Our government claims, and may even believe, that it is managing the economy. This, however, is not the case. The economy is influenced by the trading activity and the purposes for which bank lending is granted. A practical manager would, therefore, seek to encourage the former and obtain power to supervise the latter in the national interest.

Obviously much needs to be done. For a start, credit creation theory and monetarism should be abandoned and replaced by bilateral monetary theory or, taking in the wider issues, dare I say it – Haranism!

T. B. Haran
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Unemployment and the demand for labour – from Mr Henry Haslam

Another common fallacy about unemployment: any argument based on the concept of the 'demand for labour', as if employers/consumers are one class of people and employees/workers are another. Employment is mutual: we produce goods and services for each other. Most people are both workers and consumers.

The potential customers for the unemployed do not have to come from those who are already earning and spending money. An important pool of potential customers lies in those who are without jobs. One person would like a job making cars, so that he can buy a fridge-freezer; another would like a job making fridge-freezers, so that he can buy a car – for example. As long as there are people like this, who aspire to a higher standard of living and are willing to work for it, the opportunity for reducing unemployment exists. To realise this opportunity requires entrepreneurial skills to match the complementary needs, together with a pay-and-prices structure which will encourage people to work for the pay that is offered and to buy the goods and services they want at the prices that are offered.

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Articles for the Autimn 2000 edition should be received not later than September 1st, 2000.

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