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FINANCIAL MARKETS IN EUROPE: ALL CHANGE?

A talk given by Stephen Green, Executive Director, Investment Banking and Markets, HSBC Holdings plc, to members of the Economic Research Council on Thursday 22nd March 2001

If I were to tell you that 'The average German spends more on flowers than he does on equities' you may be a little surprised. You may even question this statistic. And you would be quite right to do so. The quote comes from a managing partner at a Frankfurt private bank and as far as I am aware it is genuine; however, he was not talking recently but almost nine years ago and at the time less than one in 20 Germans invested in shares.

Today, one in five Germans own shares directly; and last year, 80% of trades on the Frankfurt exchange are made by private investors. I doubt if German horticulture has undergone quite such a dramatic boom in recent times. European markets have gone through a revolution in the last few years. We have seen the introduction of the Euro, the spread of privatisation, a large increase in cross border mergers and acquisitions and increasing share-ownership by the man on the street.

This evening I want to touch briefly upon the significant changes we have seen in the European equity markets in recent years and on the implications of this growth for market practices, infrastructure and systems.

The Potential for Future Growth

Back in 1985, Continental Europe represented 8% of world equity market capitalisation. Today its proportion has almost tripled to 22%. Once the Japanese equity market dwarfed Europe; Europe is now twice the size of Japan. Things can change incredibly quickly. Ten years ago the largest stock in Continental Europe was Royal Dutch, a veritable giant with a market value of £23bn. At that point it was nearly 200 times as big as Nokia, a little known conglomerate which produced everything from tyres to TV sets and even toilet paper. Today Nokia and Royal Dutch are not much different in size. And while Royal Dutch is still doing much the same thing, Nokia is the world leader in mobile phones.

Recent months have seen some sharp reversals in equity markets, of course. But that in no way means the end of a period of rapid change. In fact I believe we are really only at the early stages. The European markets, especially the equity market, are poised on the edge of a period of rapid secular growth. If we thought the changes of recent years were challenging enough, I suspect this future growth will drive even greater and perhaps more radical change.

The Pensions Timebomb

First, there is the much discussed 'pensions timebomb'. We are probably all aware that the European population is ageing, but the sheer extent of the change likely to take place is hard to comprehend. Greater life expectancy and lower birth rates are the reasons behind the rise in what actuaries call the dependency ratio. If I were born in 1901 I could have expected to live until 45 and my wife would have lived to 49. We would probably have had three or four children surviving to adulthood. A girl born today in Europe can expect to live until 80, and the average woman has 1.7 children in her lifetime. Retirement was a luxury a hundred years ago; now it is both common place and relatively long. Clearly these changes do have implications for how we fund retirement. In the UK by 2030 there will be 2.5 workers for every one person over 65; in Italy the situation is worse – there will only be 2 workers for every one person over 65 in 2030. Today in both countries that same ratio stands at around 4 workers for every one over 65. The demographic time bomb is a problem throughout the Continent.

Most pensions today in Europe are financed using the pay-as-you-go method. People working now pay for those currently retired. Bismarck introduced this system in Germany as long ago as 1889 and up until now it has been very successful. In the UK the system is similar although the link between National Insurance contributions and what is actually paid-out to pensioners has been broken. Across the whole of Europe state funding accounts for 84% of all pensions paid out. But the actual amount of government expenditure on pensions differs markedly throughout Europe. In the UK government pension expenditure is just 5% of GDP, whereas in Germany, Spain and France it is around 10% of GDP. In Italy almost 15% of GDP is spent by the government on pensions.

In the UK, state pensions provide a minimum, and occupational and private schemes top-up that minimum. In the rest of Europe state pensions still provide most of the cover. However, the burden of taxation to keep these systems going in the future is simply going to be too high. In Spain, for example, with no change to the current system, government pension expenditure as a proportion of GDP will double from 9% today to 18% in

2050. This clearly poses a considerable challenge for the sustainability of public finances. Spain is not alone; most of Europe except for the UK is facing similarly stark statistics.

Assuming governments do not want to raise taxes there are a number of solutions to this problem. First, governments can reduce the growth in pensions paid out. One method of doing this is by increasing the retirement age. This has already been done by increasing the female retirement age in the UK, Belgium, Austria and Greece. Alternatively, governments can tie increases in the state pension to inflation rather than earnings growth, as has already been done in the UK (although this link is coming under considerable pressure from interest groups, which are of rising political importance to all parties). Governments could also try to influence the demographics themselves by encouraging immigration (we have seen tentative steps in this direction in Germany). But quite apart from the political and social aspects of this, encouraging immigration itself may not give the balance of workers required in the new high-skill economy. The real truth is that, increasingly, governments will simply have to encourage the development of a pensions industry to channel private sector savings in to pension investments.

The implications of this for the European financial markets are immense. As of now, long term savings in Europe amount to about 11 trillion euros. This figure includes all forms of long term assets such as mutual funds, life assurance assets as well as occupational pension funds. That's a big pool of investment money. It translates to around 120% of European GDP. What is perhaps more interesting are the differences within Europe. The UK is already relatively well funded in terms of pensions, with total assets of over 3 trillion euros. This is more than 2 times GDP, a proportion similar to the US. In Germany, by contrast, long term savings assets are around a third the size of those in the UK, despite a much larger economy. If we assume that Germany and much of the rest of Europe catch up with the level of funding in the UK, we estimate that this will require an increase in assets under management of around 40 trillion euros over the next 20 years. That is annual growth of 8%. This would require savings of half of the annual increase in GDP, although there would be some offsetting falls in tax as the state system would be less burdened.

When you look at the components of long-term assets, something even more dramatic emerges. Much of the current stock of long-term assets in continental Europe is invested in bonds. If, as is likely, we see a marked shift into equities, the growth rate for stock markets will be even greater.

Bedding Down of the Euro

There are several reasons why this shift to equity will gather momentum. The first is the European Monetary Union and its associated market impact. Already, the single currency has led to dramatic changes in the bond market. There were 11 separate bond markets in 1998, which have now more or less condensed into one market. Although there is still a spread between Italian and German bonds it is insignificant compared with the past and in terms of movements they are more highly correlated. (I am afraid to say one impact of this has been a fall in demand for bond economists – having only one bond yield to talk about reduces the need for large teams of analysts!) The other major impact has been to increase interest in other debt instruments. With little opportunity to diversify amongst government bonds the obvious step is to look at corporate debt. This is a relatively immature market in Europe compared with either the US or the UK; it is likely to be one of the fastest growing investment markets in Europe in the next decade.

For equity markets, too, EMU has had a hugely positive effect. The most obvious is that comparisons of companies are considerably easier and clearer when currency effects are eliminated. The effect on European pension funds will be very significant. The currency matching principle commonly used throughout the EU is that 80% of pension fund assets must be in the same currency as the liabilities. So pre-EMU a French pension fund would typically have around 80% of assets in French francs and a maximum of 20% elsewhere. Their investments in Germany or Italy would count in the 20% allocated to foreign currencies. Now the German and Italian investments are treated as effectively domestic. (As an aside, it is worth noting that the effects across the Eurozone do not cancel each other out: you might have thought that on the one hand we have French funds selling French assets to buy German and Italian assets, whilst on the other hand we have German and Italian funds selling their domestic equities to buy French equities. Surely this is a classic zero sum game? This however, assumes that the relative size of pension funds in each market is the same as the relative size of the equity market. This is not the case. In 1997 the Netherlands accounted for a much larger proportion of Euroland pension assets than it did of Euroland equity market capitalisation. Therefore as Dutch fund mangers sell Dutch equities there are not enough funds flowing in from elsewhere to fully compensate. This conclusion has been borne out by recent performance. The Netherlands underperformed Europe in both 1998 and 1999.)

The Developing Equity Culture

But as important as the arrival of the Euro is the development, Europe-wide, of an equity culture amongst investors, both institutional and retail. This has been a complex phenomenon – partly encouraged for ideological reasons by governments from the 1980s onwards (remember the *'Don't forget to tell Sid'* campaign) – partly by the rapid growth of the mutual funds industry in the 1990s; and recently by the beginnings of on-line trading. The recent flotation of T-Online, the German internet service provider, used a computer generated character called *'Robert T-Online'* to sell the idea of investing in equities. Breaking down this barrier to investing has been something governments and companies have been very successful at doing in the last decade. The retail proportion of most new issues has frequently been the most popular.

This increase in equity holdings by the retail sector has of course been assisted in a major way by key privatisations throughout Europe. Across Europe, privatisations in the telecoms industry in particular have had a huge impact – even if more recently share price performance in this sector has been poor. The German government's sale of Deutsche Telekom is often credited with having helped the emergence, more or less overnight, of a new German equity culture, especially at the retail level. The same can also be said of the UK's experience some years earlier with the privatisation of British Telecom. And I doubt whether the recent travails of the telecoms sector will have any great dampening effect in the longer term. The fact is that the genie is out of the bottle. Last year, in France the number of direct shareholders in listed companies increased to 5.5 million people or 13% of the adult population. This is up sharply compared with the previous year. It is even more interesting when breaking it down by age group. The biggest increase was in the under-25 group that saw a 30% jump in share ownership and of course these are the investors of the future. In Germany the growth in the equity culture has been even faster with 19% of the adult population now owning shares, double the level in 1997. Nonetheless, there is still room for substantial improvements from these levels; only 12% of Europeans overall own shares, compared with around 40% of Americans. As with so many things the UK is in between with 27% of adults holding shares directly.

And then, on top of the pensions time bomb, the bedding down of the Euro and the development of an equity culture – there is a fourth important factor affecting the European markets: corporate restructuring.

Corporate Restructuring

This is not the time or place for a detailed discussion of the European corporate sector. But it is a commonplace that in several countries the sector has been characterised by structures and financial incentives which have not focussed as single mindedly on shareholder value creation as in the US (and, more recently, the UK). In addition, in some markets, notably Germany and Italy, a large number of privately owned mid-sized firms have formed the back-bone of the economy. But a combination of generation change and the need to access capital is providing an increasingly insistent urge to float all or part of the business.

Tax changes are paving the way for corporate restructuring, too. In Germany in particular conglomerate structures and cross-shareholdings have been a long-standing feature of the market. Hitherto, it has been prohibitive in tax terms to unwind such arrangements. But from next year, German companies will be able to do so free of all capital gains tax. The implications for the German equity market will be enormous. Many of these cross shareholding arrangements were first formed in the second half of the nineteenth century, or early twentieth century. Allianz, for example, owns 22% of Dresdner Bank, and Dresdner Bank owns 10% of Allianz. Given that these holdings were acquired many years ago, the book value of these assets on the balance sheet is close to zero. The market value however, is much higher. If either company had sold its stake two or three years ago, they would have been liable for tax at 58%. From next year, the gain will be free.

So let me recap so far: we have already experienced a fair amount of change in the European markets, but the potential for future growth is enormous. This will be driven by the change in demographics and associated need to reform the pension system, the 'bedding down' of EMU, the development of equity cultures, and radical corporate restructuring.

Towards Euro-Perfect Competition?

But what are the implications of this for market practices and infrastructure?

Let me start with market practice: conscious that I am speaking to a group of eminent economists, I did something I have not done in a number of years – pick up a first year economics textbook. I wanted to see exactly what is required for perfect competition. After all we can consider the equity market practices in the context of a place where people buy and sell goods i.e. shares in companies. As we all know the traditional requirements of perfect competition are really quite rigorous:

- All market players must have perfect information
- There must be no transaction costs
- You need a large number of comparatively small buyers and sellers, so that the activity of any one cannot influence the market price
- No barriers to entry or exit

Of course we never, or rarely, see examples of pure perfect competition in real life. But I want to use this template, not to look the pricing of companies themselves or call into question the capital asset pricing model. Rather, I want to look at the institutional mechanics of the market itself, from the point of view of the market practitioner.

First, it is clear that a lot of apparently mundane, but actually quite significant change, is already taking place. Just last month, SAP, a large Germany company, which provides software systems to other companies, announced a proposal to change its preference shares into ordinaries. At first this does not seem very significant but it is indicative of several important trends in Europe. The growing equity culture is making investors more relaxed about risk. Investors no longer need to be goaded into taking on equity by giving them the security of preference shares. Second, stock market indices are becoming increasingly important. One of the main reasons for this move is to get into one of the key European stock indices, the growth of which I will touch on later. With its share capital split between ordinary shares and preference shares SAP was not big enough to get into one of the key new European indices, but together it would make the grade.

SAP was not the first company to do this and it will not be the last. Metro, the German retailer did the same thing last year, and RWE the electricity distributor has swapped two-thirds of its preference shares for ordinaries. Other stocks in Germany such as Henkel, BMW and VW are all expected to follow suit – it is just a matter of when.

Another example of apparently mundane technical change concerns the unit price of a share itself. In the UK we are used to share prices ranging from a few pence to £10 or £20. However, this is not always the case. Take the example of Roche. Like many Swiss companies Roche has a very high price per share, around £5000–6000 per share. For a small investor this in itself is a barrier. However, here too we are seeing changes, Roche has just announced a share split of 100 to 1 reducing the price of a share to around £55. Swiss law is changing in May this year to make such share splits possible. Novartis another Swiss pharmaceutical company has announced a similar share split. Both companies cited attracting retail investors as one of their main motivations.

But despite these and other such changes, it is clear that, when we come to apply our template from the economics textbooks, there is still a long way to go.

First, perfect information: information on prices is pretty good and widely available through services such as Reuters and Bloomberg or through web sites like Interactive Investor and neuermarkt.com. But information on the companies themselves is less easily accessible.

Perfect information is, of course, an unrealistic goal. The cash flows of the company being bought or sold are not known with certainty by anyone, not even the company itself. This has been amply demonstrated in the dramatic rise and fall of technology stocks. Future cash flows of any company are difficult to forecast with precision. When it comes to the new economy it becomes very hit-and-miss indeed. Even slight changes in the gradient of projected income can have huge effects on share prices, such that companies like Cisco Systems or Amazon.com are notoriously difficult to forecast. And many people in my own industry have had their fingers burnt trying to forecast these stocks.

But it would be at least reasonable to expect all parties to have equal access to information. Yet, the average retail investor has limited resources compared with a professional fund manager; and even the professionals run into some unnecessary difficulties when trying to evaluate European stocks. In particular, accounting standards still vary far too much across Europe and even within countries. This makes comparing two companies even on simple accounting ratios very difficult.

The retail sector is a good example of this. Consider such companies such as Metro in Germany, Tesco in the UK, Rinacente in Italy or Ahold in the Netherlands. All have very different accounting polices. Take discounts received from suppliers; we might imagine that they would be taken out of costs but Rinacente in Italy takes these discounts as financial income. Some Catalogue companies net delivery costs off sales rather than add them to costs. The accounting treatment of leases can also be very different. For example, Metro keeps leases off balance sheet and does not capitalize them as is the case with most other retailers. If you were to put them back on the balance sheet it would almost double Metro's invested capital. The treatment of goodwill on acquisitions also differs amongst these companies. All of this makes comparison of the companies' balance sheets very difficult. Analysts have to spend a lot of time restating the accounts and even then the full information needed to restate properly is unlikely to be available. Clearly this can lead to persistent share price and valuation distortions which inhibit the efficient functioning of the capital market.

This leads on to the next point – transaction costs, and in particular the settlement and clearing costs arising from buying and selling shares. Today, it can cost from up to ten times as much to clear and settle an equity trade in Western Europe as it does in the United States.

Why should this be the case?

Once a security has been traded we need a Central Securities Depository to maintain the records of all holders of the security, and to facilitate contractual settlement in the – now standard – electronic form. In Europe the domestic Central Securities Depositories have been built to support the local trading environment. Consequently, in Western Europe today we have fourteen local Central Securities Depositories supporting the Equity Markets in addition to the Cedel and Euroclear infrastructures. In the US there is only one Central Securities Depository – the Depository Trust & Clearing Corporation.

Further, in the US the National Securities Clearing Corporation, a wholly owned subsidiary of the DTCC acts as a central clearing counterparty to all exchange traded transactions. As well as reducing risks, through collateralisation of open positions, the NSCC allows for settlement netting which significantly reduces the number of contractual settlements and reduces costs. Europe has lagged the US in establishing central counterparty services, even within local equity market, (although four clearing houses, including the LCH in the UK, provide some services to market participants). However, the full benefits of central counterparty services have yet to be delivered in Europe.

All in all, there are twenty major infrastructures providing clearing and settlement services in Europe, against just two in the US. Each of those structures have their own processing routines, their own rule books and their unique regulatory and legal arrangements

The multiplicity of systems causes stress in securities processing. Nokia, for example, is now listed and traded in Germany, Finland and Sweden, and the shares can be settled in the local CSD in each of these jurisdictions. Many end clients also wish to settle through the Euroclear system. The end result is multiple movements of the same security across four different settlement systems, which requires support from local clearing and custody agents, which adds prohibitively to transaction costs. It is this fragmentation of infrastructure that is the major cause of inefficiency; it increases operational risks and results in an uneconomic cost structure that ultimately inhibits cross border flows of capital.

We, and most of our peers in the European Securities industry, believe strongly that a significant re-shaping of settlement systems in Europe needs to take place over the next decade, through horizontal integration of existing infrastructure. There are many barriers to this consolidation; the key issue is the need to change legal and regulatory frameworks as well as market practises and structures. These are complex technical issues; all made more complicated by issues of self-interest and even national sovereignty. Nevertheless, this change has already begun with a series of mergers and alliances established, which we expect will ultimately lead to consolidation into a single European Central Securities Depository.

In the case of clearing, the first steps are now also being taken. The LSE announced only a few weeks ago that it would introduce central clearing. Euronext, the exchange that includes Paris, Brussels and Amsterdam already operates a central clearing system. However, Deutsche Borse and the other European exchanges either do not have this system or are still developing it. Hence the changes are still only piecemeal – ideally there should be one European system that allowed the netting off of both national and cross border transactions. This would really lower transactions costs, and have a significant influence in facilitating an active, liquid European market place.

So to re-cap – information is far from perfect and is certainly not shared by all market participants. Second, transaction costs are high and widely varying across systems. Going back to our model of perfect competition the third criterion is a ***large number of buyers and sellers***.

This is perhaps the least of the problems; at present, there are well over twenty such exchanges in Europe. In addition, there are several electronic networks for dealing between major institutional buyers and sellers. Over time, the pattern will clearly change radically. It is safe to say that Europe will end up with far fewer exchanges; but exactly how the process of merger and rationalisation unfolds is hard to predict. Often, national and commercial considerations interact in very problematic ways (as the LSE experienced last year). But one thing we can be reasonably sure of is that both institutional and retail players will have ready access to the market – the on-line era is making that inevitable.

Finally, The fourth criterion for perfect competition is ***no barriers to entry***. Theoretically if an investment bank or fund manager wants to sell to customers in another EU country there should be no barriers to them in doing this. This forms part of the requirements of the EU's Investment Services Directive. The reality is, however, that many countries still place a number of restrictions on doing this. For example, suppose you have a particularly good pharmaceuticals and biotechnology orientated fund and you wish to sell this fund to clients in the rest of Europe. If you want to sell the fund into Italy, you have to completely translate and modify the prospectus, and then you must also get all the individual markets included in your fund approved by the Italian regulator. You can imagine what the red tape is like, and it can take more than a year to get approval to sell the product.

Another example of market barriers occurs when companies wish to raise capital. In theory, the ISD says they can use the same prospectus to satisfy the requirements of every EU stock exchange. In practice, however, most exchanges impose additional requirements demanding, for example, details of local tax treatment.

So far as merger and acquisition policy is concerned, the EU has spent almost 10 years trying to agree a Take-Over Directive. Late last year, the European Parliament amended the draft Take-Over Directive to transfer the power to make decisions as to whether to accept bids from a target company's shareholders to its Board. The vote was spearheaded by German MEPs, who unapologetically expressed their desire to protect EU based companies from hostile foreign take-overs. They clearly had Vodafone's take-over of Mannesmann in mind.

The final shape of the Directive will probably be settled by a committee under Europe's so-called 'co-decision procedure'. In the meantime, we have to continue to live in the real world with all the confusion which that involves over the jurisdiction of national regulators in cross border mergers. However, there is some good news to report: the German government has recently produced a strong new bill which would create a legal environment for take-overs which is appropriately supportive of shareholder value creation.

Another market barrier arises from corporate ownership patterns. Governments often hold large controlling stakes in privatised companies, which are used for non-commercial 'public policy' objectives. And two-tier share structures are frequently used to give certain shareholders (often family groups) disproportionate influence. All shares are clearly not equal.

For example, two groups own 7% of Ericsson, but have 56% of the voting rights. Such arrangements are not unknown in the UK (e.g. the Daily Mail) but are much less common. Only 6% of top UK companies have two-tier share structures, compared with 26% of other European companies. And as a result, the 'free float' in Europe is substantially lower in other European markets (70%) than in the UK (92%). It will take time for such shareholding structures in Europe to be dismantled; but progress is slowly being made.

One final sign of the state of flux in the European markets as convergence takes hold is the flurry of new stock market indices which have appeared in recent years. As Europe becomes a more harmonized place for companies to list and investors to trade, we will see a unification and consolidation of equity indices and market benchmarks. Just a few years ago if you were a UK fund manager all you had to be concerned with was your performance relative to the FT All Share or the FTSE 100. Similarly in Germany fund managers concentrated on the DAX 100 broad index or the DAX 30 for blue chips. Now with one currency in much of Europe and an increasing trend towards Pan European investment a whole new set of targets has appeared. We are getting around one new index a month; FTSE's new European tech index is a good example. Even to the professionals this explosion of indices has created a confusing array of benchmarks to choose from. I suspect that just as in the case of the exchanges, the big index providers will eventually merge or co-operate with each other to provide a few well-respected indices. Those indices not able to attract a following will just disappear. The US provides a good example in this respect. There are several popular indices covering the US market – the Dow Jones Industrials, the NASDAQ and the Standard and Poors 500. Also US investors often use the Russell 2000 as a smaller companies benchmark. Such universally excepted Pan European standards are not currently available; but they will emerge during the next few years.

A Decade of Blooming Rest and Recreation?

In conclusion, Europe has experienced a lot of fundamental changes in the last few years. We have seen the arrival of the euro, a burgeoning equity culture especially in Germany and France, many privatisations and companies starting to focus on creating shareholder value. But we are still some way from an efficiently functioning, harmonized financial market, and there remains a lot to do. Painstaking regulatory work, detailed preparation for enhancement of technical structures, more and more transparency of accounting and market practices – all this adds up to a major work programme for Europe over the next five years or so.

But the prize is well worth it. There remains lots of room for expansion. German equity market capitalisation is still only 60% of GDP compared with almost 200% in the UK and 170% in the US. There is also considerable room to improve market practices, lower trading costs and increase liquidity. The projected continuation of growth will force change in these areas and exchanges in Europe will need to work together to this end. Governments and regulators will need to do their bit in helping to make accounting standards much more transparent and the regulatory environment more equal and user friendly.

If I look back on all of this from the vantage point of 2020, I am sure I will see a more effective and efficient market with a much smaller number of exchanges, streamlined clearing and settlement and more equality between the asset structures of the various European nations. However, we live in dynamic and changing times. None of the above is an undeniable certainty. All I can be sure of is that we will be kept busy – the coming decade will not be one of rest and relaxation. And as to the German horticultural industry, with which I began – well, I am sure that too will be a big growth industry!

HOLDING GOVERNMENTS TO ACCOUNT

Extracts from a talk given by Lord Saatchi,
Conservative Treasury Spokesman in the House of Lords, to members of the Economic Research Council on Tuesday 6th February 2001

One day in the Oval Office, President Nixon and Secretary Kissinger were discussing a difficult affair of state. Mr. Nixon proposed a solution. Mr. Kissinger disapproved: 'Mr. President, I must remind you of the famous saying, "You can fool *all* of the people *some* of the time, and *some* of the people *all* of the time, but you can't fool *all* of the people *all* of the time ...".' President Nixon leaned back, thought carefully, and said: 'Henry! Those sound like pretty good odds to me.'

Today our government is playing the same odds.

When this government was formed, its leaders knew they could not win elections by offering to raise taxes. So they hit on a brilliant plan – to cut visible taxes on voters and raise invisible taxes elsewhere. They resolved to take full advantage of the complexity of the tax system. So, first, there has been a proliferation of tax rates. According to the latest figures from the House of Commons Library, the number of basic tax rates has leapt from 15 to 38 under this Government. *Tolley's Standard Tax Manual*, the bible of tax accountants, has grown from 2,529 to 3,293 pages in three years. The latest Pre-Budget Report ran to 345 pages from the Treasury, plus 126 pages from the Social Security Department. The Finance Bill has grown to a record 570 pages in two volumes, taking tax legislation to more than 6,000 pages.

Secondly, the Government is now collecting £30 billion a year in tax from the same 17 million households to whom it pays £30 billion a year in benefits. The Government first taxes people on low incomes. Then it means-tests their income to check they are in need; then it offers them benefits to restore their income to its pre-tax level; finally, it taxes the benefits.

One result of this bizarre interaction is that the earnings of a single mother will more than double if she works 16 rather than 15 hours a week; but they will fall if she works 27 hours as opposed to 26 hours a week. Another is that a pensioner wishing to claim the Government's new minimum income guarantee must complete a 40-page form. Of 500,000 eligible pensioners, only 23,000 have attempted the feat.

The result of such complexity is lack of transparency. The concept of stealth tax is well known. But the current system has spawned an even more effective form of taxation hidden in the morass – economists call it 'fiscal drag'.

Most people believe that the tax system now takes around 38 per cent of GDP. But that is just the net effect. The gross system collects a staggering 53 per cent of GDP. The citizen then has to claim back 15 per cent of GDP, £150 billion, by navigating more than 250 tax allowances, reliefs, exemptions, credits, indexations, tapers and disregards.

The charm of such a large gross tax system, for the Government, is the scope it allows for hidden tax increases via reduced allowances. The Chancellor can increase tax without ever announcing a tax rise. People just wake up one day to find they are in a higher bracket, so that tax as a percentage of GDP is creeping up invisibly. That is how the 'strong public finances' have really come about; not because of the 'strong economy' – but because this is the third year in a row in which tax receipts have risen twice as fast as people's earnings.

The institute of Chartered Accountants says the tax system is now so complicated it has 'spun out of democratic control'. No citizen, however intelligent, can match the massed ranks of No 10, No 11 and the Treasury. Somebody needs to carry the torch for transparency, simplicity and openness in the system, but who?

It should be Parliament, of course. But one House is disabled in this area – the Lords. In the House of Commons, scrutiny of the last Finance Bill took 101 hours. In the Lords, it took just two.

Why? It stems from a decision in 1909, when the Lords threw out Lloyd George's Budget. The Parliament Act of 1911 followed and would govern our constitution for the rest of the 20th century. That Act provides in Section 1(1) that: 'If a money Bill, having been passed by the House of Commons … is not passed by the House of Lords without amendment within one month after it is sent up to that House, the Bill shall be presented to His Majesty and become an Act of Parliament notwithstanding that the House of Lords have not consented to the Bill.'

But what was the motivation behind the Act? The record seems to show that it arose from the hereditary nature of the Upper House.

Commending the Parliament Bill to the Commons, the Liberal Prime Minister, Mr Asquith, said of the hereditary principle: 'Let it not be our master. So say we. It is because it has been our master …because it enslaves and fetters the free action of this House, that we have put these proposals before the House and we mean to carry them into law.'

Winston Churchill, campaigning for the Parliament Bill, asked: 'Why should their children govern our children? Why should the sons and the grandsons and the great-grandsons have legislative functions?'. He hoped the Bill would be 'fatal to the hereditary House of Lords'.

But consider how much has changed since then. The House of Lords Act 1999 removed the hereditary peers. Baroness Jay of Paddington, the Leader of the Lords, says that the reformed House is 'more democratic, more legitimate, more authoritative'. Membership of the Lords now includes seven former Chancellors, seven former Paymasters-General and nine former Chief Secretaries to the Treasury – as well as many professors of economics, academics and men of business.

Professor Norton's Commission on 'Strengthening Parliament', saw 'no reason why the Lords should not monitor the impact of Bills in the economic sector', and the Institute of Chartered Accountants suggested 'a technical Finance Bill scrutinised initially by the reformed second chamber'.

The Lords has often proved undaunted by the details of technical legislation. It has the expertise and authority to help the Commons to hold governments to account over public finances. What it lacks is the power; which is why it may be time to re-examine the conventions surrounding that most iconic of all Acts – the Parliament Act itself.

The Government says we have to deal with financial matters the way we always have because 'we've been doing it that way for centuries'. How ironic that a government which so despises 'the forces of conservatism' should be in thrall to events of 100 years ago to uphold history and tradition as the basis of future policy!

A RAILWAY TRAGEDY

By Peter Davison

The deaths of four people on the railway line at Hatfield a little while back was described, as is every untoward death nowadays, as 'a tragedy', this even though the number killed was, fortunately, much less than other, relatively recent accidents. On the scale of past railway accidents in the United Kingdom, the numbers killed were small. One thinks of the worst-ever rail accident in the UK, that at Gretna Green in 1915, in which 158 people died, or that at Harrow in 1952 when 112 were killed and only slightly fewer, 92, at Lewisham in 1957 and 53 at Hither Green in 1967. Nevertheless, 'tragedy' was not wholly misapplied. I would apply it not to these obvious objects of our sympathy, but to the interference of governments of various colours into the running of our railways, and indeed to much else. Governments seem to have a fixation that they can do something creative; that their interference can make things better, more efficient, more economic, more just. Over the past two centuries there is not much, I think, of which governments can be proud. The Reform Acts, perhaps, the Elementary Education Act of 1870, Old Age Pensions, the National Health Service, might all be worthy of admiration, but as one looks at the way the last three have been developed by successive governments, the picture is much bleaker. One instance will suffice. As I write this, I hear on the radio a young woman praising continuous assessment as part of her modern-language university course. The reason: because she was now 'doing nouns and verbs'. Oh dear!

But it is the particular tragedy of the railways to which I wish to draw attention. The economic advantages of a reliable, fast, safe, railway network for passengers, mail and freight is so obvious as not to demand demonstration. Various governments have believed they can 'get the railways back on track' (if I might use such an expression). I have by me two splendid leather-bound volumes which open out into huge maps showing the railways of England, Wales, and Scotland. They are adjuncts to the Railways Bill, 1921, and they are entitled *The Grouping of Railways*. They were the property of O. R. H. Bury, Esq., whose name is embossed in gold on the cover, and he was to become a member of the Board of Directors of the London & North-Eastern Railway. The maps show the many dozen railways that formed the network. They include the A&LRR, the FY&NR, the S&DR, and, perhaps my favourite, the Wantage Tramway. The map is coloured to show what the LNER would take over and, in double colours, what lines it would share with one of the other three major companies, the LMS, GWR, and SR. The 'Grouping' took place on 1 January 1923. Eight years later, on 15 August 1931, the *Economist* noted that 'the position of the railways, when 'grouping' was achieved in 1923, was particularly difficult'. Considerable efforts were made to improve the service, not only in the running of famous, 'named' trains, in races as to which could reach Scotland more quickly by the east-coast or west-coast routes, but in such delights – or, at least, delights to me – of a cinema-coach at the rear of the Newcastle-King Cross service about 1935.

During the war, the railways, still grouped into four companies, took a fierce battering. They were obviously bombed (one train was bombed fifty yards from my wife's house, whilst they were in the house), they carried very heavy loads, and maintenance was difficult. The railway stock was so run down that even ex-Army railway engines had to be pressed into service after the war to replace the companies' worked-out engines. The railways were an obvious target for nationalisation and the immediate post-war Labour Government brought this about from 1 January 1948, just twenty-five years after the grouping. The railways were still, in effect, grouped (by Region), but they now formed part of a single unit run under the aegis of the British Transport Commission. From late 1949 until early 1952 I edited a journal about railways, and I notice that in the same month as I summarised the British Transport Commission's first annual report, November 1949, the Chancellor of the Exchequer, Sir Stafford Cripps (formerly Minister for Economic Affairs), announced in the House of Commons 'that there is to be some reduction in the standard of maintenance of the railways'. *Some reduction in the standard of maintenance of the railways!* Summarising the third BTC report in August 1951, I noted that the Treasury had, in 1950, cut the amount allowed for maintenance and replacements by eight per cent: 'Consequently', said Lord Hurcombe, 'the Railway Executive cannot maintain the railways as they would wish'. *Cannot maintain the railways as they would wish!* What was particularly galling was that it was not Treasury money that was cut for maintenance, but the Commission's own money: 'no question of a Government loan was involved'. My summary continued, 'If capital investment in the railways continues to be so restricted the railway system will become a national liability instead of an asset'. If I could see that aged 25 and without the benefit of a university education, surely the Chancellor of the Exchequer might also see it? I concluded that, if railwaymen felt the railways were not worth working for, they would drift into other occupations. That was Labour's contribution. I think, but cannot lay my hands on a document stating this, that, at nationalisation, the Treasury took to itself all the money put aside by the railway companies out of savings and reparations for war damage, destined to rehabilitate the system, so that the nationalised rail system began with no money in the bank.

What of their rivals? I suppose the Conservatives' greatest contribution to emasculating the railway system is summarised in the one word, 'Beeching'. Harold Macmillan appointed Dr Richard Beeching (ex ICI) head of British Railways in March 1961. A year later he produced his plan to close 2,128 stations, cut the rail network by a quarter, scrap 8,000 coaches, and sack 67,700 staff. The Government (now under Lord Home), announced the closures in March 1964. At the end of the year, when Harold Wilson was Prime Minister, Dr Beeching was sacked.

Well, was that the Tories greatest contribution? Perhaps not. The Race to Privatise ignored all the problems posed by the multiplicity of companies pre-Grouping (What, after all, is History?) and, as we know, split everything up into a hundred parts. Whether they were required by the EU to separate track from the rest is unclear: I have seen two sharply conflicting accounts. However, New Labour, in the person of Mr Prescott, before taking office, promised loudly and firmly to bring the railways back into public ownership and we are often regaled with repeats of his blustering statements (there are more than one) at Labour Party Conferences. Now, to ensure our confidence in the railway system, he is taking command through a series of regular meetings. In the meantime, we have the saga of the London Underground system to engage our interest. So, in the words of the Anglo-Saxon poet, Deor, 'That was overcome; so can this be'. Can't it?

Governments' mismanagement of the railways is a tragedy but it is only one of many. It cannot even send our soldiers to Sierre Leone with anti-malarial pills which any holiday-maker can use and which I enjoyed nearly sixty years ago. Every politician should read, in addition to George Orwell's 'Politics and the English Language', Shakespeare's *Richard II*, which dramatises the way words and actions fail to correspond at crucial moments. Gaunt's rebuke to Richard should be emblazoned on tablets on their desks: 'Shorten my days thou canst with sullen sorrow, /And pluck nights from me, but not lend a morrow'. Medieval kings and modern governments can take away, can destroy, but rarely create.

Note

For any who are puzzled: A&LRR = Axminster and Lyme Regis Railway; FY&NR = Freshwater, Yarmouth and Newport Railway; and S&DR = Somerset and Dorset Railway.

THE MPC'S RPIX SUCCESS*

By Jonathan William Carr Prince

Up until midway through 1997 the base interest rate was controlled by the Chancellor with advice from the Treasury and the Bank of England. However on the 6th May 1997, shortly after the Labour government had come to power, operational responsibility for setting interest rates was given to the Bank of England's Monetary Policy Committee (MPC) by Gordon Brown who described the move as 'the most radical reform in the Bank's 300 year history'.

In a speech in May 1999 John Vickers, the Executive Director and Chief Economist at the Bank of England, defined price stability as 'low and stable inflation'[1]. As can be seen from Table 1, underlying inflation (RPIX – the Retail Price Index excluding mortgage interest payments) has averaged

* This is the winning article of the Spring 2001 Economic Research Council's Young Contributors Competition. Mr. Jonathan Prince is in the sixth form at Tonbridge School

2.6% since the Bank was given independence and in the two years 1999 and 2000 inflation has come below the government's target at 2.1%. As well as keeping comfortably within the government's inflation target of 2.5%, the MPC managed to prevent a recession that seemed imminent in 1999 by quickly reducing interest rates as is shown in Table 2.

Table 1 UK Inflation Annual Percentage Change During the 1990s

Year	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
RPIX	8.1	6.7	4.7	3.0	2.3	2.9	3.0	2.8	2.7	2.3	2.1

Since an independent group now controls interest rates, the best interests of the economy are given priority. Prior to the creation of the MPC, monetary decisions were strongly influenced by public opinion and party politics at the expense of stability. This was especially evident in the period running up to elections. For example during the final year of the last Conservative government, there existed increasing pressure for higher interest rates in order to stem the accelerating consumer spending. As is clear from Table 2, Kenneth Clarke's reluctance to raise interest rates, resulted in their remaining at 6% for his final eight months as Chancellor. It was then not until the spring of 1997 that the risk of inflation was addressed with the Bank of England engineering a controlled slowdown in the growth of aggregate demand. This was seen to be effective as inflation headed downwards in 1999 as can be seen from Table 1.

The record of other independent central banks around the world is very encouraging and is a good reflection on the MPC for the long term. The US federal reserve for example has achieved low inflation for a long period of time together with high output and employment under the leadership of their erstwhile Chairman Alan Greenspan.

Although it is certainly the case that the British economy has enjoyed low inflation since the birth of the MPC, the credit that should be given to them is debatable. The fact that the UK's underlying rate of inflation has stayed within 1% of the government's chosen target of 2.5% for over eight years, as shown in Table 1, suggests that significant steps towards price stability had been achieved prior to the birth of the MPC. High interest rates that were adopted by Norman Lamont, the Chancellor at the time, successfully brought down inflation during 1991 to 1992 as is clear from Tables 1 and 2 which paved the way for sustained stability.

Table 2 Base Rate Changes in the 1990s

		New base rate (%)
1993	26 Jan	6.00
	23 Nov	5.50
1994	8 Feb	5.25
	12 Sep	5.75
	7 Dec	6.25
1995	2 Feb	6.75
	3 Feb	6.75
	13 Dec	6.50
1996	18 Jan	6.25
	8 Mar	6.00
	6 Jun	5.75
	30 Oct	6.00
	31 Oct	6.00
Bank made independent		
1997	6 May	6.25
	9 Jun	6.50
	10 Jul	6.75
	7 Aug	7.00
	6 Nov	7.25
1998	4 Jun	7.50
	8 Oct	7.25
	5 Nov	6.75
	10 Dec	6.25
1999	7 Jan	6.00
	5 Feb	5.50
	8 Apr	5.25
	9 June	5 00
	8 Sep	5.25
	6 Nov	5.50
2000	13 Jan	5.75
	10 Feb	6.00
2001	8 Feb	5.75
	5 Apr	5.00

Although monetary policy has played its part there are other factors that have contributed to this period of stability. Global effects have definitely helped to keep inflation low. Markets are now more competitive than even a decade ago which alone acts as a force towards lower prices. Consumers are now experiencing greater choice and receiving more information on prices across national boundaries due to former monopolies being subject to deregulation and free trade areas together with single markets rapidly expanding.

The reduced power that employees now have in the labour market has also had a significant impact on price stability. When wages rise only slowly due to low inflation, consumers are more price-sensitive resulting in companies being restrained from passing along price increases.

The reduced inflation has also been a self-sustaining factor alone in that expectations of price increases have fallen having an impact on wage negotiations. As workers do not have to seek large pay rises to protect their real incomes wage inflation is kept under better control.

A recent study from the National Institute of Economic and Social Research (NIESR) in October 1999 claimed that the eventual outcome for inflation and economic growth with interest rates held constant at 6% over the first two and a half years of the MPC's life would have been virtually identical to the macro-economical profile achieved with over numerous base rate alterations[2]. This tendency to adopt a policy of too many interest rate changes may also be destabilising for the economy in the medium term. It must also be noted that the period of 1993 to 1996, before the existence of the MPC, saw a very similar outlook in terms of stability as can be seen by the inflation figures in Table 1. Together with the corresponding, and again very similar range of interest rate changes in this period, as can be seen from Table 2, the argument supporting the MPC's existence seems somewhat damaged.

The extent to which stability has been created in the long term is also unknown due to the existence of time lag. This implies that a period of up to two years can be needed for any interest rate changes to feed through the economy and make any impact on the retail price index.

Overall however the MPC can take some of the credit for the low and steady rate of inflation that has been achieved in the economy and, despite the existence of other factors, it must be acknowledged that they have made a valuable contribution to the creation of price stability within the UK.

References

1. Glasgow Trades House Lecture, 26 May 1999 (Geoff Riley in November 1999 Economics Today 'Trends in UK Inflation')
2. Geoff Riley – 'The UK Economy 1990–2000'

STAKEHOLDING: THE JAPANESE BOTTOM LINE

Robert J. Ballon and Keikichi Honda,
Published by The Japan Times, 2000, £17.00

Robert Ballon, a professor at Sophia University, I have met twice – in 1979 and again just last year. Born in Belgium and having spent much of his time since 1948 in Tokyo, he now has an insider's feel for Japan, scorns visiting economists who 'come here to apply their foreign economic models' and leads the teaching team for the EU's representative office induction programme for newly arriving business managers. Keikichi Honda is chairman of Sun Microsystems K.K. and, based on a Tokyo University Law degree, has had an impressive managerial career in Japan.

Given Japanese thought patterns and a French speaking mind writing in English one often has to wrest meaning from verbiage. Try this one:

> Governance for the Japanese does not mean control over given assets and liabilities through internal integration; it means a constantly evolving effort to coordinate stakeholders whose interests are divergent unless brought back to convergence by coordination. Corporate governance is, then, relational governance. Concretely, it addresses stakeholders who know one another through repetitive and flexible transactions, whereby multiple goods/services are handled simultaneously. The time dimension is crucial, and so is the space dimension: Both permit control of opportunistic behaviour by the reputation effect. (Introduction, page 17)

With this kind of guidance, it is clear that the Japanese are, indeed, hard to understand!

Nonetheless, in the end this book is much more important than its authors intended. To explain. The statement above, which says that rather than following a simple profit motive, managers in Japan try to satisfy everyone at the same time, would be treated by most of us with sceptisism. But there is much truth in it. Established, large Japanese companies do feel a sense of obligation to many parties.

Take, for example, Japan's giant telecoms company, NTT. Telephone charges in Japan are notoriously high. Looking at Internet access costs for its 31 member countries, the OECD's most recent survey sates Japan as *the* most expensive, for 20, 30 and 40 hours of peak time access charges, and among the most expensive for off-peak access charges. Consumers are thus providing the funds that elsewhere would be raised from shareholders. You bet they are buying a 'stake' in the enterprise'

At the same time employees in NTT are not unionised in the western sense and have little chance to change employers. Through their weak wage-bargaining power – they are, in effect, allowing a portion of their income to be taken as funds for investment – again funds that elsewhere would be raised from shareholders. Meanwhile, NTT obtain supplies from numerous smaller sub-contractors, many of which have been described as 'sweatshops' who recieve lower payments than they would if greater competition existed. Money thus withheld is again funds that elsewhere would be raised from shareholders. All these parties need their sense of injustice to be balmed over with sweet words about being 'stakeholders' in the enterprise and promised thereby at least some extra security for their expenditure.

But no one would want to say these things so bluntly in Japan and so it is left to writers such as Ballon and Honda to make the point indirectly as if in approval. We hear about not only consumers, workers and sub-contractors but also banks, public officials, financial institutions, retailers and everyone else and we learn about their cooperation, their sacrifice, their long term trust and relationships and the 'sensible' need to restrain the forces of competition in order to make the 'stakeholder' system work. And they say it very well indeed.

However, the wider picture cannot be ignored. We all know that Japan has a 'surplus savings' problem to which most economists here and in America respond by advocating measures to increase expenditure, to encourage the people to blow their savings. If necessary, some even go as far as Paul Krugman and advocate the deliberate stimulation of inflation which, in effect, would steal the people's savings. In fact, as Richard Katz has demonstrated in his book 'Japan, the system that soured' Japanese personal savings in relation to national income have changed little over the past 30 years. It is *corporate* savings that have exploded enabling firms to make investments *without* using the people's savings. Corporate savings have risen precisely because prices are too high, because wages are too low, because prices paid to sub-contractors are too low and because profits are not paid out to shareholders. All these effects reflect hobbled competitive processes which elsewhere are the key to enable a market economy to work. 'Cooperation' and 'stakeholding' are thus at the heart of Japan's economic problems.

To return to NTT. This is a company with tremendous investment opportunities provided by the explosive growth of new telecoms technology. It should be a major sponge soaking up surplus savings. The problem is that it has its own funds.

Ballon and Honda's observations and perceptions ring true. The overall picture is of wealth with no identifiable controlling owner – wealth that is at the same time huge, unaccountable and enigmatic. The obvious link is with that other long seasoned observer of the Japanese scene, Karel van Wolferen and his description of the vacuum at the heart of political power described in 'The Enigma of Japanese Power'.

Political power without a holder and wealth without an owner. Eventually someone must step forward and exercise this power and claim this wealth. Are we looking towards a Henry VIII taking over the monasteries and a political leader who, in an unexpected circumstance finds little check on the exercise of absolute power? Who knows? But one is left with an uncomfortable feeling ...

J. B.

COMPETITION REQUEST

With this edition of Britain and Overseas members will find a separate page entitled 'Competition Announcement' and 'Application form'. The Council would be pleased if you can hand this to a suitable contact in university or school education to encourage further submissions.

LETTERS

Two responses to The Case for the Euro, by Simon Buckby, from Mr H. W. Haslam and Mr B. C. Jones.

Sir,

As a reader who is very much an amateur economist, I welcomed the article by Simon Buckby in the Winter 2000 issue as an introduction to the issues concerning the Euro. May I put in a request that the debate be continued in Britain and Overseas at the same serious, yet comprehensible, level? And may I start by offering a few queries and comments?

The article's principal argument, that volatile exchange rates are unstable and damaging, is powerful and cannot be denied. But if this is so, why do we not have a single world currency? What happened to the gold standard? What happened to the Breton Woods system, the old East African shilling, and the Sterling Area – to name but a few? What were the reasons, several times in the last 40 years, when the British government made sudden changes in the exchange rate of the pound? It was certainly not that governments failed to understand the value of stable exchange rates. Are the answers to these questions fully understood by economists and government ministers, and why are these answers not relevant to the euro? If the answers are that governments were either foolish, or ignorant, or powerless, why should Euroland be different? If, in the past, so many governments, when faced with economic realities, have decided, with great reluctance, that to maintain a fixed exchange rate was not the best option, what confidence can we have that life in the euro will be different? Brian Kettell, in the same issue of Britain and Overseas, describes what might happen if one country were to find that remaining in the euro had become unsustainable.

If a single currency is such a good idea, why are we not working towards a single world currency, or at least a single currency for the world's major economies? Why does the euro not maintain a fixed exchange rate with the dollar, the currency of the world's largest and strongest economy? If there are good reasons for the euro and the dollar to remain independent and travel in different directions, do not the same reasons apply to the pound? In the recent situation in which the dollar and euro have been diverging, perhaps the middle course has been better for the pound than being tied to one or the other.

The other arguments in the article seem less important, less relevant, or less convincing. In particular, the argument about jobs being lost is weak. In the modern world, there are always old jobs that are disappearing, for a multitude of reasons, and new ones that are being created. That is the route to greater prosperity. The loss of specific jobs for a specific reason may be a personal tragedy for the individuals involved but it carries no weight in a macroeconomic argument.

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Sir,

Arguing the case ‘for’ the euro Simon Buckby claims that whereas in the United States regional balance is maintained through Federal payments (taxing prosperous areas heavily and spending money in areas of high unemployment), such transfers will be unnecessary in Europe because of fiscal devolution. He said ‘Every individual nation state within the European Union is responsible for raising and spending its money because it has fiscal control. That of course is the in-built automatic stabilizer …’

Economists have always known that if a nation has an overvalued exchange rate relative to its trading partners (resulting in an outflow of money as imports exceed exports) then, apart from devaluation it has the ‘alternatives’ of attracting compensating capital flows (inward investment, borrowing abroad, foreign subsidies) or the migration of unemployed workers to other full employment nations.

But the idea that fiscal control can compensate for exchange rate misalignment is totally false. Changing government tax and expenditure policies cannot correct an imbalance in the flows of funds in and out of the country. Put another way – if you have a bucket with a hole in it, you can stir up the falling quantity of water as much as you like, but you will still end up with an empty bucket!

B. C. Jones
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