



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

Summer 2010

Vol. 40, No. 2

Restraining our Leaders – <i>Eamonn Butler</i>	3
The Outlook for the World Economy is Exciting – <i>Jim O'Neill</i>	13
Spending our way into Unemployment – <i>Damon de Laszlo</i>	19
A Good Deal of the Financial Services Industry appears to be Plain Criminal, and in a sense 'Legally so' – <i>Paul Breslaw</i>	21
Things Economists can't tell us, and Why – <i>Robert McGarvey</i>	24
Beware China!	28
Astounding New Element Discovered	29

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RESTRAINING OUR LEADERS

A talk given by Dr Eamonn Butler, Director of the Adam Smith Institute, to members of the Economic Research Council on Tuesday 30th March 2010¹

The State of Britain

I want to talk about the state that Britain is in and what we need to do about it. I think this is larger than elections, I think it is larger than which party happens to get into power, I think this is a serious problem which has grown recently and which we must do something about. So I am not going to just tell you that thirteen years ago we stood on the edge of a precipice and since then we have taken a great step forward; I am going to tell you that we really do need to address our system of government in this country.

If you want a good laugh, don't buy my book,² buy Roy Hutton's book that he wrote in 1995 which is called *The State We Are In*, and it's a really good laugh. So you read that today and what is he saying? He is saying Britain is a proud nation who have to live in a tarnished country. Industry, he says, is stagnating. We've got high unemployment, he says. We are isolated in the world. This is 1995, OK? We've got a sick political system. We've got over-centralised decision-making. The independence of the courts has been undermined. The Civil Service has been politicised. We've got patronage rather than accountability. Pensions have been raided. Millions of us have negative equity. We've been overtaken by more successful foreign competitors. Well it seems to me that all of that is even more true today.

The 'Marketing Opportunity' for T. B. Labour Ltd.

So here we are, and my colleagues and I down at the Institute were prepared to give this government the benefit of the doubt, to give Tony Blair the benefit of the doubt, and we have tried to work with it, and I must say, within a year it became obvious to us that this wasn't a real political party at all, this was, as John Prescott said, a 'marketing opportunity'. This really came home – I forget the exact date, I think it was in July 2008 – when

1 It was known at that time that the General Election would be held on May 6th.

2 'The Rotten State of Britain' reviewed in *Britain and Overseas* Vol 39, No 3.

the Welfare Minister, Frank Field, who had been brought in to think the unthinkable, did in fact think the unthinkable. So unthinkable that they fired him. And I thought, well that's it. If they are not actually going to do anything radical there is no point in bothering about these guys. We tried, we stuck with them for a while but nothing very much happened. It is part of the problem that we have that our politicians live in this world in which they have to come up with initiatives and eye-catching headlines and all the rest of it rather than to deal with literal policies.

Funded by Debt

So I think we've sunk pretty low. We've sunk far lower than Hutton thought we were in 1995. You've only got to look at the economy to see that. We've got a deficit of 14% or whatever it is, four times the 3% deficit that we tried to recommend and impose on the rest of Europe. Our national debt is at wartime levels – Second World War and Napoleonic war levels – and I think that it is at least six times understated. I think there is so much that is off the books, so many liabilities, pensions, public sector pensions, all sorts of things, Network Rail obligations, well, you name it there are dozens of these things, and I think the real national debt is probably about six times what it is on the books. We have had a decade of boom and then bust. We were told that we were going to have an end to this and yet somehow it hasn't happened. We have had public spending which has risen by 50%. In some cases, like health, it has risen by 300%. The budget has gone up by three times. And yet, has it bought us all that much extra public service? There are still, for example, despite all the health spending, 2½ million of us still on incapacity benefit. We are supposed to be getting fitter and yet even more of us are on incapacity benefit. There is something very strangely wrong here.

And to me it is blindingly obvious. We are over-spending hugely, we are over-borrowing hugely when we need a big cut in public expenditure to start with, which might roughly get us back to where we were in 1997 and I don't, quite frankly, think anybody would notice the difference. But you've got to do it in a sensible way.

Canada Reshaped its Government – we could too

I think government has just grown and grown and grown in all sorts of weird and wonderful ways and we have to rethink it. That's what the

Canadians did in the 90s when they faced a budget deficit that was akin to ours – it wasn't quite as much as ours – and they reversed that in five years. And they reversed that in five years by completely rethinking what government is all about, and they asked every minister, what is it that your department exists to do? Focus on what it is you are supposed to do and throw out all the rest. Of those things that it has to be there for, can it actually be done better outside government, or can it be done better inside government, can it be done in a better way? So it's a complete rethink job, and I think that is what we need in government. But I speak to a lot of Conservative spokesmen, who all say, Oh, no, no, no, we couldn't possibly do that. The first couple of years we are going to be fire-fighting, we are going to be worried about where the next pound is coming from, and I say, No, if you actually want to reduce your public expenditure, that is the way to do it. Don't think of it as a tough exercise, think of it as a reshaping government exercise. When you have reshaped government and concentrated it on the things that it really has to do and cut out the things that it doesn't have to do, then you will find that government has become a lot cheaper. But, which politicians are going to bite that bullet? I don't honestly see any that will.

Education and Health – Yuk!

It seems to me that public services aren't performing either. Again, the education budget has doubled in ten years. 98% of kids pass their exams. Over half of them I think, get A* to C grades, and yet we have a large proportion of the population – estimates vary, 50%, 40%, 30% - are functionally illiterate – in other words they can't find a plumber in the phone book. We've got universities that don't trust the results of examinations; we've got teachers who complain that they are overloaded with central initiatives. And what's the big idea to solve this? Well, you know, it's been Jamie Oliver! The same is true in the NHS – again, the budget has risen about three times with no obvious improvement in the output. Of the 200,000-odd people who die of cancer in Britain every year, 30,000 of them would not die if they lived anywhere else in northern Europe. So, it's no wonder that 70,000 of us go abroad every year for medical treatment. And, what's the big idea there? Well of course, it was Lord Grossman, and he didn't last very long, did he?

Justice – Help!

i) We are all Terrorists?

And the thing that really does bug me is the state of justice in the United Kingdom, which I do think is particularly alarming. We have introduced draconian anti-terrorism legislation and those laws have been misused against the ordinary law-abiding British public and that is something which I thought could not happen. I thought that we had constitutional safeguards in place that would prevent that happening, and yet it has happened. A case in point would be the case of Iceland where, obviously Landsbank went bust or was about to go bust and Iceland's assets in the UK were frozen under the Anti-Terrorism Crime and Security Act of 2001. Now this is legislation which was introduced in the wake of 9/11 in order to protect us against the threat of terrorism and the loss of life and a clause in that bill says that everybody who is threatening the economic welfare of Britain or of any British citizen can also fall into this. So 240,000 I think it is of our staunchest allies in the European region if you include Scandinavia in Europe, our staunchest allies, our greatest friends, suddenly discovered that they were all terrorists according to our legislation. And it's no wonder they were a little bit upset. I think I would be a little bit upset if the government called me a terrorist but it's so easy to do. There was the case of Sally Cameron who was walking her dog along a cycle path in Dundee and happened to go through this "dog slot" that was for military dogs and not ordinary dogs and two squad cars rushed up, she said it was like Starsky & Hutch, and she was arrested under the Terrorism Act because this was clearly marked as a cycle path and she was walking on it and that apparently made her a terrorist. And of course you all remember the case of Walter Wolfgang, the 82 year old Jewish man who escaped Nazi Germany and joined the Labour Party and was a Labour stalwart and, at the (was it?) 2005 Labour Conference, he decided that he'd heard enough from Jack Straw and heckled him from the back. Whereupon he was whisked out and held under the Terrorism Act.

And similarly, under the Terrorism Act there was a provision which you might think was extremely sensible, that the police were given powers to stop and search anyone they felt they should stop and search, without having to show any cause for why they should be stopped and searched. And you thought, well, that's fine, somebody's walking up and down outside a power station all day, or looking a bit suspicious outside a rail station or something, obviously a ne'er-do-well and might be planning to plant a

bomb or something, well that's totally reasonable. The police should be able to stop and search these people. As soon as the legislation was passed, ministers had to decide which areas they would make stop and search areas. And you thought that was fine, yes, a power station, or a military location. No, the whole of London has been created a stop and search area where you or I can be stopped and searched by the police, without them having to show any just cause at all. This clause actually means considerable inconvenience, I have to say, in Westminster, where if I do an interview with the TV or something, and I go out on the streets to set up shop, you can guarantee that a squad car is going to rush up and they are going to produce a yellow form, and we are all going to have to give our name, address, sex, height, weight, ethnic something or other; this is unbelievable that this can actually happen.

ii) Free Speech?

And free speech is being curtailed it seems every day and it is not just political correctness. Officials can stop and fine you if you drop an apple core or something like that, they can spot fine you and if you don't pay that's another £5000 you've lost. You can be subject to an ASBO with absolutely no evidence at all, and if you break it, well – somebody got an ASBO because their canary sang too loudly – and if you break that, well, that's a criminal offence and you can go to gaol. It struck me as absolutely unbelievable that I should live in this sort of country.

iii) Habeas Corpus?

Trial by jury has been suspended in some cases. Habeas corpus, well, you can already be held for 28 days and the government would love to make it 42. Double jeopardy – I can see why – yes, if somebody is clearly guilty on DNA evidence of something they were acquitted of twenty years ago, I can see why people want that person to be brought to justice, but at the same time there must be a clearer picture here – should we hassle and harass people. Should we allow the state to prosecute them over and over and over again? The rule is there precisely so that the government cannot do that to people and yet now they can.

iv) Presumption of Innocence?

The right to remain silent? You don't have it any more in some cases. The presumption of innocence? Once again, you don't have it any more in some cases. The Proceeds of Crime Act made it so that anything you

have can be confiscated until you can demonstrate that you got it legally. The police recently raided – a complete “fishing trip” – raided a security box company and they opened 500 security boxes, and I have to say, yes, they found drugs and revolvers and all sorts of other stuff that people keep in security boxes, and they also found cash and they found jewellery, and many of those deposit boxes were the property of perfectly innocent people who had got cash and they had got their mother’s jewellery or whatever, and they had put them there, and they had to prove that they had got these goods legitimately, otherwise they might never see them again. Now, just a minute, this is completely the wrong way round. We have completely reversed the proof of guilt here.

The Problem is Unrestrained Government

So what’s going on? The problem, as I see it, is one which was expressed by Sir Karl Popper many years ago, is not how to choose our leaders but how to restrain them. America knew this when it set up the Constitution with its separation of powers. They knew that the Executive – they were mindful of George III and all the rest of it – they knew that the Executive had to be restrained. They knew that anybody in any position of authority has to be restrained. And the problem is that we seem to have lost all of the constitutional restraint on our leaders.

And so we have huge centralisation, principally from Downing Street where everything is decided, not by elected politicians but by party apparatchiks, we have “initiative-itis” where, again in order to reach the headlines you have to be doing something all the time, whether or not – and I’d like to see politicians say, no, actually we shouldn’t do anything about this problem at all; we should let it sort itself, or even that we should go back and reflect for about a year before we do anything like this. But no, we don’t, we have the Dangerous Dogs Act, and everything that goes wrong you have an initiative to try to solve it. And just as the stop and search stuff has separated us from the police, and we now see the police as agents of the state rather than guardians of our own welfare, the same sort of thing has happened with this “initiative-itis” and overcentralism. We are getting estranged from government. One initiative recently of course is the initiative about child protection where people who deal with children have to have criminal records checks. Now on one level that’s perfectly reasonable, but in fact what is happening is that people who would normally volunteer to help out at school, run and support clubs, be a coach, take some kids to

the seaside; it's just not happening any more. Ordinary respectable people say I've got nothing to hide but I'm just not going to go through that process. It's demeaning. It's not the sort of relationship that there should be between me and the government. And I am sure that that will be reversed and people who deal with children now realise the damage that it is doing, and the threat that it is trying to overcome is actually much less than the damage that it is doing.

And of course you have in the system as well political careerism, which again further erodes the strength of our politicians. 120 people in the House of Commons owe their living to the government, either ministers or whips or other officials, so that's where the perks and the pensions and the cars come from, and so it's not surprising that they are all totally up for Downing Street. I don't think this is going to be solved by electing a different bunch of people, but I think it has to be solved by a major shift in the power of government, and as Mrs T did for the economy, the next prime minister really has to do for politics, which is to move it out of the political system.

Mugabe and the Abuse of an Informal Constitution

The UK has a constitution but it's an informal constitution. There's a lot of legislation there. There's the Magna Carta, the Bill of Rights, and all sorts of stuff, but at the same time we have a sovereign parliament which congenitally overrides any law that it wishes to. It can override things like double jeopardy, trial by jury, and all the rest of it, just by an Act of parliament. Sure, you've got to have a full head of steam before MPs and Lords will sign up for this sort of thing, but the Prime Minister in Downing Street commands the majority in the House of Commons, and quite commonly can raise a majority in the House of Lords, and therefore can do almost anything, quite unlike an American President who is restrained. American Presidents are forced to go to Congress; sometimes they have won and sometimes they haven't but there are some restraints on them and there is the Supreme Court. Blair, of course, the archetypal hero, came in with a very big majority and saw that as a mandate for leadership, and anything that got in the way was deemed to block it; I'm here, I know what the people want, I am the people's Prime Minister, this is what the people want. If the Civil Service objected, or parliament objected, or the Cabinet objected for that matter, or the Royal Courts objected, they were just pushed out of the way. Mrs Thatcher started it, I think, quite frankly,

but at least Mrs Thatcher, when one thinks about the Civil Service, while she hated them because they got in the way and they slowed stuff down when she wanted to do all these dynamic free market things that we all believe in, she nevertheless respected their judgment and respected their constitutional role. They are there to make sure that legislation is properly drafted and that drafting isn't just thought up on the back of an envelope. And the result of this centralism is that you have what is effectively elected dictatorship. I would say that if America had colonised Africa we wouldn't have any problem there today because we would have written constitutions and everybody would know the limits of their power. But in fact since the British colonised it – with rules like cricket, where what's in the spirit of the game is OK and what isn't isn't supposed to happen. But of course you've only got to get a swine like Mugabe and you've had it. And this is the sort of world that we are getting towards.

Mutual Backscratching

And then the media world certainly has been another pressure for centralism. 24-hour media, I'm not decrying it, I think it's absolutely fantastic but it is always highlighting problems and therefore always demanding that politicians should do something about it, so for a politician to say, well it's not within my power, or actually I shouldn't have the power to do that, it's not going to play in the media at all is it, so again you get politicians absorbing power in order to please a branch of the media, you get initiative-itis, you get more control, more quangos, and that again leads to the growth of government.

And the growth of government in turn makes government a career and none of the people I know who are Members of Parliament, they started as student politicians, and then they worked up through their work for a PR company, or their work for a trade union, and then they got into a local council in a bad seat, and then a good seat, and then they became ministers, and so on and so on. And it's just a career path. There was a time when people saw a career in parliament as being temporary public service; you were there for a short time and you were there to do some good, and you didn't see it as a career. Now it is the perks, and the pensions and the fortune and the cars, and they all depend on the Prime Minister's patronage. And that again erodes the division between the party and the state. As we saw when Blair arrived, Alistair Campbell was put in charge (a party man, not elected by anybody) of certain Civil Service functions and within a few

months he had replaced all the government's press officers with people much more in tune with Labour's thinking. The division between the party and the state has been lost and you get insider dealing with the press, with ministers basically releasing public information, let's say tomorrow's unemployment figures, leaking it to favourable journalists who will then write a favourable article, and it's a mutual back-scratching organisation.

Solutions

i) Give up Some Powers

I think it depends entirely on (unless there is a revolution which I think is unlikely in the near future) having some leaders who are prepared to do the unthinkable, which is to give up power. We could have a US-style separation of powers. I think we can go there, and I can see the benefits there. But when I look at the making of the EU Constitution, I think that any new constitutional initiative is extremely dangerous.

ii) Give up Some Ministries

I think also that we need to have a government which is prepared to work with fewer ministers and fewer departments – Jesus had twelve and discovered that that was one too many – and I could run this country with eleven ministers quite easily. The size of a football team is a good thing. I think we need fewer MPs, I think also we need term limits on Members of Parliament; I don't think they should consider it a career. A lot of people say we'd lose expertise in that case but it's worth it, quite frankly. People who have expertise will find other ways of making a contribution, but what we don't want is for people to see a parliamentary seat as a career that will get lots of perks because then they are more interested in getting all of those perks rather than serving us the public.

iii) Debate the Important Issues

And I think I'd like to see parliament focus on the big issues, big issues like EU regulations which it hardly touches at all; the House of Lords does a bit on it, but there are thousands of pages of regulations which are nodded through without debate. Parliament should do things like debate the petitions which are put into Downing Street on the web site. They should debate the leading ones. They should really get more into the general public's head and the issues that concern the general public.

iv) Decentralise

The Conservatives say they will give more authority to local communities and I think that's a good idea; things like an elected police chief (I'm not so sure about that but it's the right general direction). They are pretty low calibre and nobody has much confidence in them so in saying we are going to give them more power you are on a sticky wicket. But I think if lots of people do have more power in local government then you get a much better calibre of person coming forward. This happens everywhere else in Europe, where much more is spent locally and raised locally and people have more pride in their local community partly for that reason. Looking at the finance, clearly the council tax can't support very much more at the local level so (I hate to say it because I campaigned against it) I think a local income tax is probably very sensible. You can move taxation very easily and it is visible to move it from the national government to the local government because it's a penny-off tax centrally is a penny-off tax locally and let them decide how to do it. I think that's an easy way to do it.

v) Subsidise People, not Services

And the other thing I would say is that we need to subsidise people not services. The government doesn't run supermarkets and shoe stores so why should it run schools and hospitals? We need to work out ways to make every school an independent school but to subsidise the kids to go there so the money really does follow the parents' choices. The same in health, more difficult, but again every hospital should be an independent hospital running in a competitive market and people who need medical care should get it, so nobody would be worse off but we would all benefit from competition rather than having a state monopoly.

vi) Dismiss all Quangos

I think we should have some set rules on quangos. Actually what I think we should do is to send them all home for a year on full pay or even half-pay (I don't care, I'm not mean-minded) and wake up in a year's time and say, which ones are we really missing, and then we can make them re-apply for their jobs, just as happens in the private sector; you don't just reappoint people you reapply for your job.

vii) Restore the perception of law

And I think we have to restore the perception of law; we have to give the

government a set of rules like everybody else. We have to, I think, prosecute the abuses of terrorism legislation, for example. Local government officers who use terrorist legislation to spy on my wheelie-bin habits, I think they ought to be put in gaol! (I'm not meaning to suggest that!)

viii) Establish On-line Vetting of Accounts

And another thing that would make a real difference would be on-line vetting of accounts. Fundamentally every cheque that the government writes should be posted on the internet for everybody to see.

THE OUTLOOK FOR THE WORLD ECONOMY IS EXCITING – BUT WITH RISKS!

Extracts from a talk given by Jim O'Neill, Head of Global Economic Research at Goldman Sachs, to members of the Economic Research Council on Tuesday 8th December 2009.

Here we are, fourteen months on from the collapse of Lehman Brothers and arguably the biggest financial crisis that most of us have ever come across. At least this has had the effect of pushing some countries into new directions – the US towards correcting its imbalances and China towards stimulating domestic demand. And the crisis did not affect the whole world equally. There wasn't a financial crisis in most parts of the big populated emerging countries or in some countries of the developed world such as Australia and Canada.

The next few years a 'V'-shaped rapid recovery

i) Growth

Our forecast for the world next year is a move from a contraction of minus 0.8 in 2009 to plus 4.4% in 2010 (and 4.5% in 2011). The average growth for the world over the past 25 years is about 3.6% and growth during the pre-crisis boom-heady years of 2003–2007 was about 4.5%.

So we believe that the world economy's growth rate without generating inflation is probably about 4%. At Goldman Sachs we see the 'BRICs' (Brazil, Russia, India and China) growing faster than the consensus view but the US growing less strongly than the consensus view. The UK will have a difficult 2010 but we see growth of 3.4% for 2011 – slightly less than the Bank of England's forecast of 4.1%. (Table 1)

Table 1: GDP Forecasts

% yoy	2008	2009		2010		2011
		GS	Consensus*	GS	Consensus*	(GS)
USA	0.4	-2.5	-2.4	2.1	2.7	2.4
Japan	-0.7	-5.2	-5.7	1.5	1.4	1.6
Euroland	0.6	-3.9	-3.8	1.5	1.2	1.9
UK	0.6	-4.6	-4.5	1.9	1.2	3.4
Europe	0.8	-3.7	-3.6	1.7	1.3	2.3
China	9.0	8.7	8.5	11.4	9.6	10.0
India	6.7	6.6	6.1	8.2	7.6	8.7
Brazil	5.1	0.5	-0.4	5.8	4.6	5.0
Russia	5.6	-9.0	-7.7	4.5	3.5	5.5
BRICs	7.5	5.0	4.7	9.2	7.6	8.6
Advanced Economies	0.6	-3.1	-3.1	2.1	2.1	2.5
World	2.7	-0.8	-0.9	4.4	3.8	4.5

* Consensus Economics November 2009

ii) Inflation

We don't really see, in the next twelve to eighteen months much sign of a big pick-up in inflation (Table 2). I find it fascinating that a good 80% of people I talk to don't believe this at all. Half of them are convinced that we are in the early days of a multi-year Japan-style deflation, and the other half think the complete opposite, that we are in the early stages of a rampant build-up in inflation. And there are quite a few people who think that the UK is going to have no growth but with inflation for many years in the future – which I would find very hard to believe.

iii) Recovering financial conditions

To give us confidence in our forecasts, we have, for each of 26 countries something called a Financial Conditions Index that we use as a lead indicator. This index is a combination of financial variables which tend historically to

Table 2: Inflation Forecasts

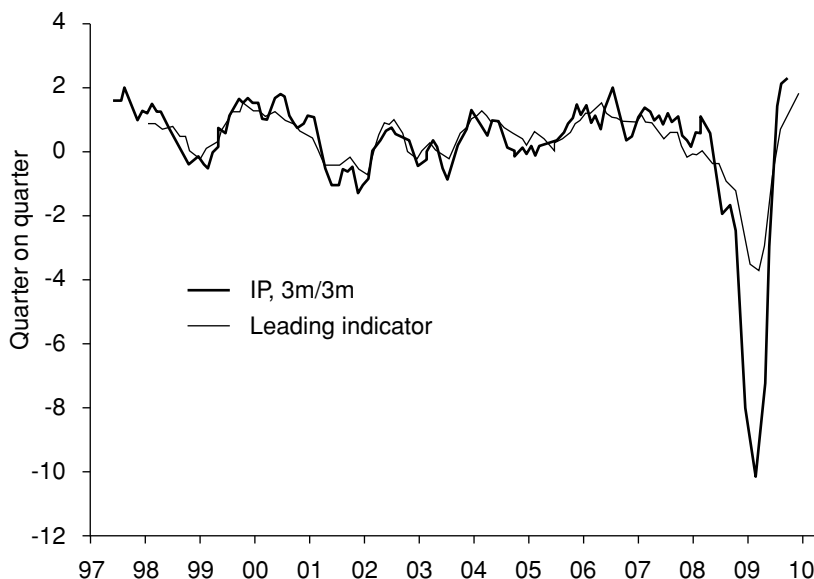
% <i>yoy</i>	2008	2009		2010		2011
		<i>GS</i>	<i>Consensus*</i>	<i>GS</i>	<i>Consensus*</i>	<i>(GS)</i>
USA	3.8	-0.4	-0.4	1.5	2.0	0.4
Japan	1.4	-1.3	-1.2	-1.0	-0.9	-0.4
Euroland	3.3	0.3	0.3	1.1	1.1	1.6
UK	3.6	2.1	2.1	2.2	2.0	1.5
Europe	3.5	0.8	0.8	1.3	1.3	1.7
China	5.9	-0.9	-0.6	2.4	2.6	2.8
India	8.3	2.7	2.5	5.0	5.5	5.5
Brazil	5.7	4.9	4.3	4.4	4.4	5.0
Russia	14.1	11.7	9.2	5.3	8.1	6.6
BRICs	7.6	2.2	2.0	3.6	4.2	4.1
Advanced Economies	3.4	0.1	0.2	1.3	1.5	1.1
World	5.4	1.6	1.4	2.6	2.8	2.7

* Consensus Economics November 2009

lead within a twelve month period what actually happens to the economies (Figure 1). Our index chart for the UK shows a huge improvement in the past two years – largely because of the drop in the pound. Britain's industry, tourism and much else has become world competitive again. Our Financial Conditions Index for the US suggests – because of the aggressive and very admirable steps that were taken by the US authorities that we should recover within a year 95% of what the world economy lost. Meanwhile, as a result of the crisis, China has undertaken a massive easing of financial conditions. Some might say that this is creating a bubble but I think that the Chinese have been really clever in moving from export dependent towards domestic demand-led growth. At one stage in 2007 China was exporting the equivalent of about 12% of its GDP alone in exports to the US, and in the immediate aftermath of Lehman Brothers, when the financial system literally stopped for about four weeks, the Chinese realised that if they didn't do something the Chinese economy could fall apart. What they did was to come up with a huge monetary and fiscal stimulus which resulted in this huge easing in financial conditions. The results are remarkable, the latest auto sales for China show a 98% year-on-year increase!

Thus the general picture is of 'V' shape (rather than an 'L' or a 'U' recovery and this is corroborated by OECD statistics. As just another

Figure 1: Euroland Leading Indicator versus Industrial Production



example we can look at the UK Services Monthly Indicator (Figure 2). Official UK data from the Office of National Statistics is often revised and we are quite confidently of the opinion that when we get another year forward the revisions that will take place will actually say that the UK left recession in the first quarter of 2009.

The 'BRICs' – Brazil, Russia, India and China

Figure 3 shows the contribution to global GDP of each of the BRIC countries, the BRIC in aggregate, the US and the Euro area so far this decade. What you can see in pale grey is the contribution to global domestic demand, the differences being due to trade imbalances. So far this decade the BRIC countries have contributed more to global economic activity than has the US. That was not the case in the previous decade.

The emergence of China and the other BRIC economies in my judgement is quite literally the most important economic phenomenon of our lives and probably our children's as well. In just the last seven years the pound value of China has increased by the equivalent of two United Kingdoms!

Figure 2: UK Services Monthly Index

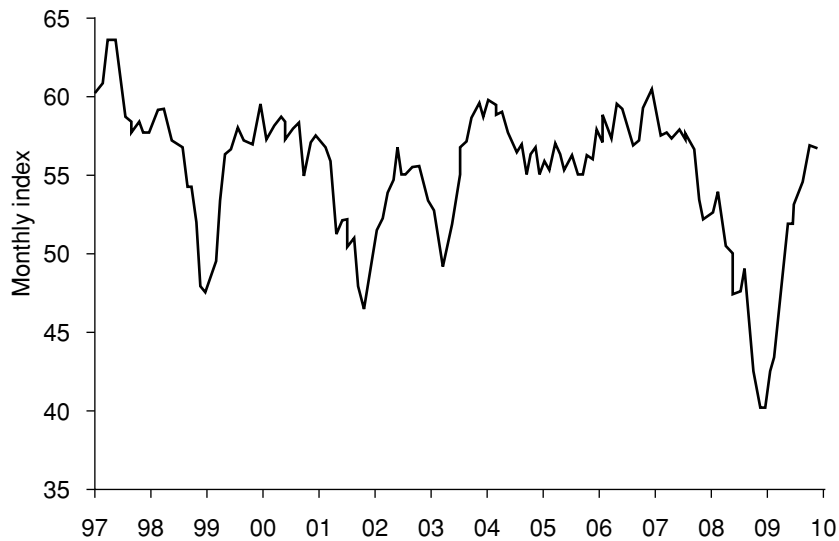
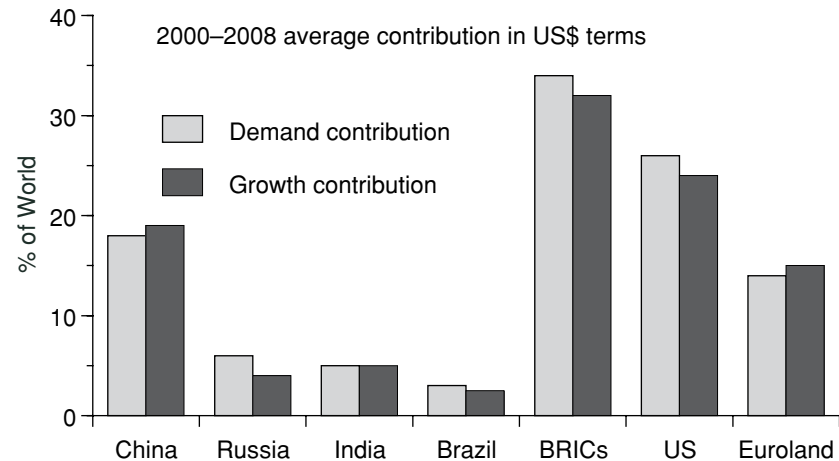


Figure 3: Domestic Demand and Growth Contributions, Last 9 Years

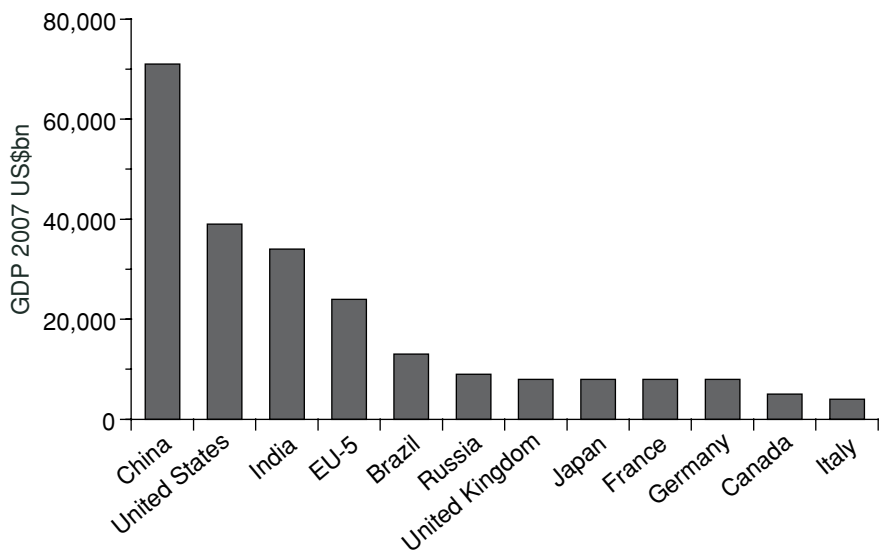


In the future it is conceivable that India, if it ever got its act together, could be just as important because – as I am sure many of you know – the dynamics of India's labour force are quite spectacular. According to some research we have done, it is conceivable that the size of India's labour force by 2035 could be as big as that of China and the US put together. We are increasingly confident that Brazil and India, like China, are entering what appears to be a new and stronger and more sustainable phase of growth. If you put the three of those countries together, you are not far off 3 billion people, which is nearly half the world's population – and, as I have said, these people do not feel like they have had their lives ruined by this global credit crisis in the way that many people here do.

The world in 2050?

Figure 4 is an up-to-date version of a picture we first published in 2003 to show the increasing dominance of the BRIC countries. We thought we'd go through an exercise as to what the world *could* look like by 2050, so I want to say that we never actually said that the world *will* look like this. I would not presume to have the slightest idea of what the world's economy

Figure 4: The Largest Economies in 2050?



will be like in thirty or forty years. This is just a stylised version of what it could look like.

Hundreds of millions of people in the developing world have been, and are still being taken out of poverty and I do believe that they are motivated, despite the blow-up in the world's financial system, to carry on down this slow path of trying to take some of the better things of western democracies to help them to get bigger and wealthier. So, by 2027 – eighteen years from today – China could become as big as the US. Brazil could overtake Italy and the UK by the end of next year and some say that the UK will slip out of the top ten economies by 2015.

The UK can benefit from all of this. If we have smart policy making going forward. If we are right with these long term projections, the UK could actually become bigger than Japan and certainly bigger than Germany. It doesn't feel like that today, given the challenges that we have, but from my experience, this country and in particular this part of the country, is in an exceptional position not just for financial services, but for virtually every other value-added international service you can think of, legal, educational, architectural or whatever. And we are in the best time zone to take advantage of the 'Britified' world into which we are going.

I will finish with the following anecdote, because it is the most powerful thing I saw when I recently spent three weeks in China. For a brief part of that period my wife was with me, travelling around. We went through a very poor village and on a dilapidated wall was a huge billboard that said 'Success in English equals success in life'.

SPENDING OUR WAY INTO UNEMPLOYMENT

By Damon de Laszlo

Since May the world's Central Banks and the respective governments seem to have split into two camps. The American government, with the luxury of being the world's reserve currency, is able to ignore for the time being both the national government deficit and the individual State deficits. There is, however, some rumbling that the individual States could go the way of Spain etc. They are required by law to balance their budgets and

some States have indeed in the past gone bankrupt. One of the perverse effects of this worry is that individuals holding dollars end up buying US Treasury Stocks, keeping interest rates at historically low levels.

In Europe it has now become fashionable for governments to announce swingeing cuts to balance their books and reduce government deficits. It is yet to be seen how effective the policies will be, but the chorus of Union opposition grows louder by the day. There is also a fascinating argument that government expenditure cuts could precipitate a double-dip recession.

The logical conclusion to this argument is that government should continue spending more than they can raise in taxes, borrowing the difference – I suppose keeping the economy apparently booming until the whole system collapses! This rather perverse argument goes along the lines that government expenditure which takes money out of the productive side of the economy and pays huge sums for ‘services’ somehow is good. The argument is also strange as most observers and economists regard government expenditure, even on the important and vital requirements of infrastructure, health and education, as highly inefficient.

As there is a very large number of people and businesses that depend on government payments, it is hardly surprising that the beneficiaries of government largesse are marshalling the arguments that go in their particular favour. The dilemma for governments today is that they have to correct the deficits caused by the spending binges of the last five years or so and inevitably this is painful.

In looking for an analogy, while drinking wine in moderate quantities is possibly good for you and certainly pleasurable, a massive binge causes a hang-over which can take longer to recover from.

It is more difficult than usual to map out the likely economic development of Western economies. One can only hope that government actions are consistent and relatively steady, not creating unnecessary uncertainty for those running the service and manufacturing industries that can grow and develop their companies and generate wealth.

There is a worrying phenomenon, however, that is caused by the massive advance in technology over the last ten years. Computers are really impacting the productivity of the service and manufacturing sector, this trend requires a higher average level of skill than is being delivered by Western education, i.e., it is going to be very difficult to get back to the old accepted levels of employment. It is doubtless politically incorrect to point out that: a) bank clerks are being replaced by ATM machines; b) agricultural workers

in the old sense are being replaced by highly sophisticated employees driving large, expensive and complex machines; c) the old production line 'factory worker' is replaced by a complex computer-controlled piece of equipment. While there is an economic tendency towards complex and sophisticated machinery to replace labour, there is also a push in this direction from governments in the West and particularly Europe.

The ever-increasing tax on labour in the guises of National Insurance or Social Security etc. is really a tax on employment. When an individual's taxes are added together, with the various employer's taxes, coupled with the employment legislation, it all adds up to a great discouragement to employment.

There is a huge incentive to automate to make one skilled person highly productive, rather than deal with the cost and bureaucracy of employing less skilled people. If automation is not feasible, this taxation and bureaucracy provides the major incentive for sending manufacturing work to Asia.

I am not hopeful that our government's desire for money will, in the short term, be reduced sufficiently for taxation to be adjusted in favour of employment, so we can expect continuing high levels of 'unemployment', with the economic consequences that follow.

A GOOD DEAL OF THE FINANCIAL SERVICES INDUSTRY APPEARS TO BE PLAIN CRIMINAL AND IN A SENSE 'LEGALLY SO'

By Paul Breslaw¹

When we read a little about the present financial crisis – be it the antics of Goldman Sachs' traders, the bonuses of the top people in Britain's bailed-out banks, the Ponzi scheme of Bernie Madoff, or the fraud at Lehman Brothers – it is quite a common reaction to feel some kind of righteous indignation towards these activities and the individuals behind them.

¹ This article first appeared in 'Associate!', the monthly journal of Associative Economics. *cfae.biz/associate*

This is especially the case if we turn our attention not to those directly affected by, say, Madoff's fraud, but to those who suffer the 'collateral damage'- the poor Americans who have lost their homes, the millions of ordinary people worldwide who no longer have a job, the businesses unable to raise money to pay their normal bills. These people – including perhaps ourselves – seem to be the hapless and innocent victims of other people's apparent wrongdoings. Almost unconsciously our sense of natural justice is triggered and we yearn for someone to be punished for what we perceive to be crimes, even if we can't quite put our fingers on which law or laws have been broken.

Admittedly, in the case of Bernie Madoff it was quite clear. He had promised to invest his clients' money and provide them with a good return on those investments. Instead he had simply paid 'interest' to earlier clients from the capital deposits of later ones. This is fraud.

But take the Goldman case. Here we have clients solicited to buy into a Collateralised Debt Obligation (CDO)² – a derivative based on the re-sold and re-packaged debts of American mortgagees many of whom had lied to their mortgage brokers (who often encouraged them to do so) about their ability to pay the mortgage instalments. It is alleged that another client of Goldman's (a hedge fund run by a man called Paulson) selected for inclusion in the CDO those debts which were most likely to default. The reason, it is also alleged, was because Paulson had taken out an insurance policy a Credit Default Swap (CDS)² – against the debts defaulting; that is, if the value of the CDO declined (which it inevitably would) the policy would pay out. The company that provided the CDS was the US's largest insurer, American Insurance Group (AIG). Credit default swaps are not regulated, so AIG was not obliged to hold enough reserves in the event of having to pay out on those it issued. When the CDO sank, Paulson made nearly a billion dollars from AIG, which was unable to pay out; so Paulson got his money from American taxpayers when the US government stepped in to bail out AIG.

To my mind this reveals exactly how hard it is to recognize a financial crime. At the very heart of the matter we have individuals hoping to make money without doing anything and without any work being done. This is not very different from betting on a horse race (where at least the horse and its rider do something) in which a number of parties dope the horses, some to run quicker and some to run slower. Doping horses is considered

2 See end of article for meaning of technical terms

illegal – the race has to be fair – but 'doping' a financial instrument is considered fair game. Why else would it be legal to use the technique of 'shorting' – that is, borrowing assets, selling them, waiting for the price to drop (perhaps itself caused by the sale), re-purchasing them at the lower price, giving them back to the lender, and pocketing the difference?

Let's be quite clear about this. If I buy a share on the secondary stock market (the normal stock exchange), or I buy a bond from my bank or from a building society, or I loan some money to a hedge-fund, I am expecting to make money without doing any work, to make money out of nothing. The more detached the financial instrument is from where 'real' money is made, the less I am likely to care (or even know) about the side effects of my investment, or even of its riskiness. Nor can I find out who else is betting on or against this investment. Warren Buffett, the most successful share investor in history, is famously quoted as saying that he never invested in something he didn't understand.

Whether we understand an investment or not, the fact is that it is a bet pure and simple, and derivatives are a kind of bet on bets. For wherever someone is placing a bet on one outcome, there is likely to be another betting on the opposite, and the final result often depends on the bets themselves. So there can be no 'fair' race. In finance, the concept of 'outcome' is merely the movement of the price associated with a piece of paper – no more, no less.

With this image in mind, it is more or less naive to expect there to be any ethical or moral component to such transactions, outside of the normal laws of contract, no matter how respectable the suit of the banker or solid the appearance of the bank. And certainly recent press descriptions of the 'culture' of investment banking and financial trading bear this out. If the accepted way to win is by definition a loss for somebody else, then anyone arriving at the office of such an establishment clearly has to leave their ethical qualms at the door. I used to work in the IT department of a financial research organisation that also engaged in trading on its own and its customers' behalf. The computer people generally ignored the trading section of the company because, as we were told, its sole purpose was to make money, plain and simple.

When much of the investment business is predicated on knowing something that other punters do not, allowing one party to profit from another, what purpose is served by trying to legislate towards full disclosure of information? Furthermore, the precepts of old-fashioned retail banking (and even the concept of money itself) depend on trust, e.g. '...promise

to pay the bearer ...'. I don't think anyone goes into a casino with that as the *leitmotiv* of his visit. Yet modern derivative investment is erected on the foundations of traditional banking while flying in the face of this precept.

If this is so, then within this kind of culture what constitutes a crime? The only answer I can give is that it is a crime if its activities spill out into an arena where people are playing by different rules. The chairman of the UK Financial Services Authority, Lord Adair Turner, has described some of the City of London's financial activities as 'socially useless'. In view of the scale of the recent financial meltdown, that is something of an understatement – socially destructive might be a better fit. As Lord Turner concludes, clearly something should be done to separate the 'casino' from the rest of us.

Note: Technical Terms

COO: A collateralized debt obligation is an asset-backed security whose value and payments are derived from a portfolio of fixed-income underlying assets.

CDS: At its simplest, a credit default swap is a bilateral contract between the buyer and seller of protection. It refers to a specified bond obligation of a "reference entity" usually a corporation or government, but who is not a party to the contract.

Derivative: An agreement to shift risk among market participants in exchange for a fee.

A key feature of all such techniques is that they make the real basis of transactions remote, but that is the nature of abstraction.

THINGS ECONOMISTS CAN'T TELL US AND WHY

By Robert McGarvey

Many not so casual observers, including Queen Elizabeth II, have wondered why economists did not anticipate the recent financial crisis. The reality is most economists were stunned when the crisis arrived, panicked at its blinding speed and can only recommend 'the same old, same old' going forward. There are two principal reasons they didn't see it coming. One, economists weren't looking broadly enough at the economy to see the

problems developing in the first place, and two, what evidence was available (and there was plenty) tended to be discounted or ignored for ideological reasons.

The Dismal Science

Economists, despite being highly respected and sophisticated scientists, have been on the defensive for centuries. Truthfully, the study of economics was in difficulty even before Thomas Carlyle levelled his famous ‘dismal science’ charge in 1850. Perhaps the one nagging criticism that stings most strongly these days is the charge that economists are so infatuated with the wonder of their theory that they ignore practical reality.

Why should the rest of us care? It’s a serious issue because economics matters. The management of a modern economy, the decisions and actions undertaken by politicians, senior policy advisors, Chairmen of the Federal Reserve Bank, business leaders, Wall Street investment bankers and others, are derived from an underlying body of economic thought; today those underpinnings rest largely on the shoulders of neoclassical economics, the foundation stone of modern capitalism.

Neoclassical Economics

Although neoclassical economics is a foundation, it is by no means a unified body of theory. However modern economists working within the neoclassical paradigm tend to agree on both a quantitative approach to economic analysis and a field of study centred on the exchange process. Neoclassicism is a mathematical system of thought concerned with market related phenomena, particularly the determination of prices, outputs, and income distributions.

This is quite a change from the past. A century ago the great Alfred Marshall could say of economics: *‘Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing. Thus it is on one side a study of wealth; and on the other, and more important side, a part of the study of man.’* These days you’ll find a much less ambitious definition for economics, generally along the following lines: *‘Economics is the social science that examines how people choose to use limited or scarce resources in attempting to satisfy their unlimited wants.’* ...a dismal science indeed.

So, where did it all go wrong?

It all happened a long time ago, in the horse and buggy days of the Victorian era. Mid-Victorian capitalism was facing a mountain of trouble. Marxism and the rising working class movement were galloping forward on the left; on the right there was a looming – cataclysmic – breakdown of *laissez faire*, which eventually launched an era of vicious protectionism and hyper-aggressive imperialism. According to economic historian Eric (Lord) Roll, in these confusing times there was a strong desire among classically minded economists to produce a more scientific study of economics and – ideally – find a way to side-step the theoretical challenge of Marxism once and for all.

The Marginalist Revolution of the 1870s provided just such an opportunity. The marginal utility theories of Jevons, Manger and Walras revolutionized economic thought and with it the entirety of economic study. Neoclassical economic theory, which emerged as a consequence of the Marginalist Revolution, introduced important new concepts into the economic lexicon, particularly a theoretical perspective that the value of goods is determined subjectively ‘in use’ by the end-user (classical economics had assumed that goods had a hard, objective value, which was equal to the amount of labour applied in its development – the so-called labour theory of value).

However, neoclassicism also introduced fundamental changes in the study of economics; its explicitly scientific approach introduced a mathematical bias into economics, which has grown significantly over the course of the past century. Unfortunately, mathematical precision has come with a hefty price tag: the Marginalist Revolution reduced the scope of modern economic analysis considerably. By drawing a ring-fence around the exchange process – forevermore the ‘legitimate’ area of economic inquiry – neoclassical economics retreated into a narrow, quantifiable definition of economics, where the larger (messy) questions were simply ‘out of bounds’. And although economists gained much greater mathematical certainty and logical consistency in adopting neoclassical principles, the Marginalist Revolution placed significant limits on the boundaries of economic study, stifling inquiry of those economic inputs that lay outside the narrow confines of the exchange process.

It was this reduction in scope, this retreat from the larger study of political economy, undertaken over a century ago that created the ‘boundary’, the theoretical wall that defines the limits of economic analysis; the presence

of which leaves economists as mere spectators in critical elements of the economy. It is one of the reasons why so many of them didn't see the storm clouds gathering in the first place and still can't.

Economists counter these charges by pointing out that their market focus is reasonable, given that every meaningful economic activity that takes place outside the boundary eventually winds up in an exchange transaction, which they believe, essentially, brings the outside world to them on their (quantitative) terms.

Yes, economists do consider 'out of boundary' inputs, but lumber them into a broad undifferentiated category they call externalities. The practical consequences of this approach, however, distance economic analysis from the primary sources of economic activity. For instance most economics are unconcerned (and presumably unaware) of the nature of new asset classes in an emerging knowledge economy or more importantly, just how these new assets impact economic risk assessment over time. In other words, economists are left to examine only the derivative (quantitative) effects of economic phenomena rather than their primary causes.

The Ideological Force of Monetarism

Unfortunately, this confusion between cause and effect has been greatly magnified by the late 20th century rise of monetarism. Like many theoretical considerations in economics, monetarism was controversial and applied carefully within the profession; while outside in the world of finance and business it was swallowed whole, hook, line and sinker. Unfortunately monetarism became more than a new set of economic principals, it morphed into an ideology, a faith like belief in the purity of markets. The practical effect of market purism has been to undermine traditional checks and balances perfected over the ages to preserve the integrity of capital. As a result capital management practices collapsed across the board when it became popular to believe that markets purified the economy of all risk. This ideological sedative infected all aspects of economic decision making, undermining the culture of banking, accounting, credit rating, management and economic policy making.

Modern Economic Thought

Modern economics, despite being an important theoretical advance on the past limits economic thought in several ways. Firstly its dedicated

mathematical approach limits the very process of economic analysis, for it implies strongly that anything that is not quantifiable simply doesn't count. Secondly its constricted focus means it looks at the economy through a microscope rather than a telescope – in other words it's missing the capitalist forest for the statistical trees. These reductive forces contribute to the fatal combination that blinded many economists in the run up to the financial crisis and are, even now, limiting our ability to put the economy back on a sound footing.

BEWARE CHINA!

The weekly financial journal *Money Week* recently summarised some reader's comments under the title 'Jump off China's juggernaut while you can' which sounded a useful note of caution in the face of the rising level of often rather naive admiration for China's economic management.

"Everyone thinks removing the peg that linked the Chinese currency to the dollar means that the renminbi (RMB) will rise. That is supposed to be good, because it raises the price of Chinese exports to the rest of the world and cuts the price of its imports. And that should help out the ailing West (by encouraging the Chinese to buy more of our stuff) and rebalance the Chinese economy too (easing inflation to keep interest rates low and forcing it to find an economic driver beyond exporting toys and buttons).

But what if it doesn't work like this? What if the RMB isn't hugely undervalued but massively overvalued? Let's not forget that while it has been pegged to the dollar it has still appreciated an awful lot against the euro and the pound this year.

It's also worth noting that, as GMO's Edward Chancellor says, China currently displays pretty much every single characteristic of a massive bubble. Just a few of these include investors' 'blind faith in the competence of the authorities', as well as the rampant credit growth and rising corruption. Real-estate investment currently makes up around 12% of total GDP.

China's economy has been compared to the film *Speed*, in which a bus is planted with a bomb set to detonate if it slows below 50mph. This seems apt, says Chancellor. 'Were China's economy to slow below Beijing's

8% growth target, bad things are liable to happen. Much of the new infrastructure would turn out to be otiose; excess capacity would linger in many industries; the real-estate bubble would burst; and the banking system would face a rash of non-performing loans. Investors who are immersed in the China Dream ignore this scenario. When the China juggernaut eventually stalls, they face a rude awakening.”

* See www.moneyweek.com/blog.aspx

ASTOUNDING NEW ELEMENT DISCOVERED

Oxford University researchers have discovered the heaviest element yet known to science. The new element, Governmentium (symbol=Gv) has one neutron, 25 assistant neutrons, 88 deputy neutrons, and 198 assistant deputy neutrons, giving it an atomic mass of 312.

These 312 particles are held together by forces called morons, which are surrounded by vast quantities of lepton-like particles called pillocks. Since Governmentium has no electrons, it is inert. However, it can be detected because it impedes every reaction with which it comes into contact.

A tiny amount of Governmentium can cause a reaction that would normally take less than a second, to take from 4 days to 4 years to complete. Governmentium has a normal half-life of 2 to 6 years. It does not decay, but instead undergoes a reorganization in which a portion of the assistant neutrons and deputy neutrons exchange places.

In fact, Governmentium’s mass will actually increase over time, since each reorganization will cause more morons to become neutrons, forming isodopes. This characteristic of moron promotion leads some scientists to believe that Governmentium is formed whenever morons reach a critical concentration. This hypothetical quantity is referred to as critical morass. When catalyzed with money, Governmentium becomes Administratium (symbol=Ad), an element that radiates just as much energy as Governmentium, since it has half as many pillocks but twice as many morons.

With thanks to Richard Gaywood, fseked.co.uk

NEW MEMBERS

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

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

OBJECTS

- i) To promote education in the science of economics with particular reference to monetary practice.
- ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.
- iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.
- iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.
- v) To publish reports and other documents embodying the results of study and research.
- vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.
- vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.

