



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

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CENTRAL BANKS, DEFLATION AND GOLD

A talk given by Mr Robert Pringle, Managing Director of The World Gold Council, given to members of the Economic Research Council on Thursday 6th February 2003

The two questions I have been asked to address in this talk are the following: first, are central banks scared of deflation? Second, what is the rising gold price telling us?

This is an interesting juxtaposition. If there is indeed a serious prospect of deflation, and gold usually rises on fears of inflation, how can these apparently contradictory signals be reconciled?

With the exception of Japan, no part of the world is currently suffering from deflation, by which is normally meant a situation of falling prices and economic recession or stagnation. But the euro area and even the US are closer to falling into a deflationary trap than at any time since the 1930s. This is because they have not adjusted fully to the excesses of the late 1990s and the excessive borrowing undertaken by consumers and companies, and in the case of the US because of the massive external deficit. In other words, the global imbalances are unsustainable, and although deflation is not yet a reality, many economists do believe the forces that will produce it are already in motion.

The question is whether these forces can be stopped or even put into reverse before they plunge us into a recession with falling prices. That is what central banks are concerned about. And they have become more worried about this in recent weeks.

Before Christmas, people like Sir Edward George, Governor of the Bank of England, were still quite upbeat about the economic prospects. He reassured people there was no imminent threat of deflation and that the central banks had the weapons to deal with it if it did develop – ‘it’s not rocket science’, he told the Treasury Select Committee. Alan Greenspan was delivering much the same message in the US.

But with the advent of the New Year, the economic weather worsened. As the Bank of England pointed out on February 6 when it announced an unexpected interest rate reduction, the economic outlook had deteriorated in recent weeks. The statement read:

Over the next two years, the prospects for demand, both globally and domestically, are somewhat weaker than previously anticipated.

In order to keep inflation on track to meet the target over the medium term, the committee judged it necessary to reduce rates.

But it is possible that we are faced with an unenviable choice – either of watching as the world economy sinks into recession or stimulating it at the risk of sparking off an unsustainable inflationary cycle?

Which way this turns out has big implications for all markets, and not least for the gold market. Equally, there are lessons to be learnt for central bankers from the recent movement of gold prices.

I will now sketch in the background to the recent movements in the gold price, then return to the central banks and in conclusion I will try to link the two.

What's going on in the gold market? An explanation for the price rise 2001– February 2003

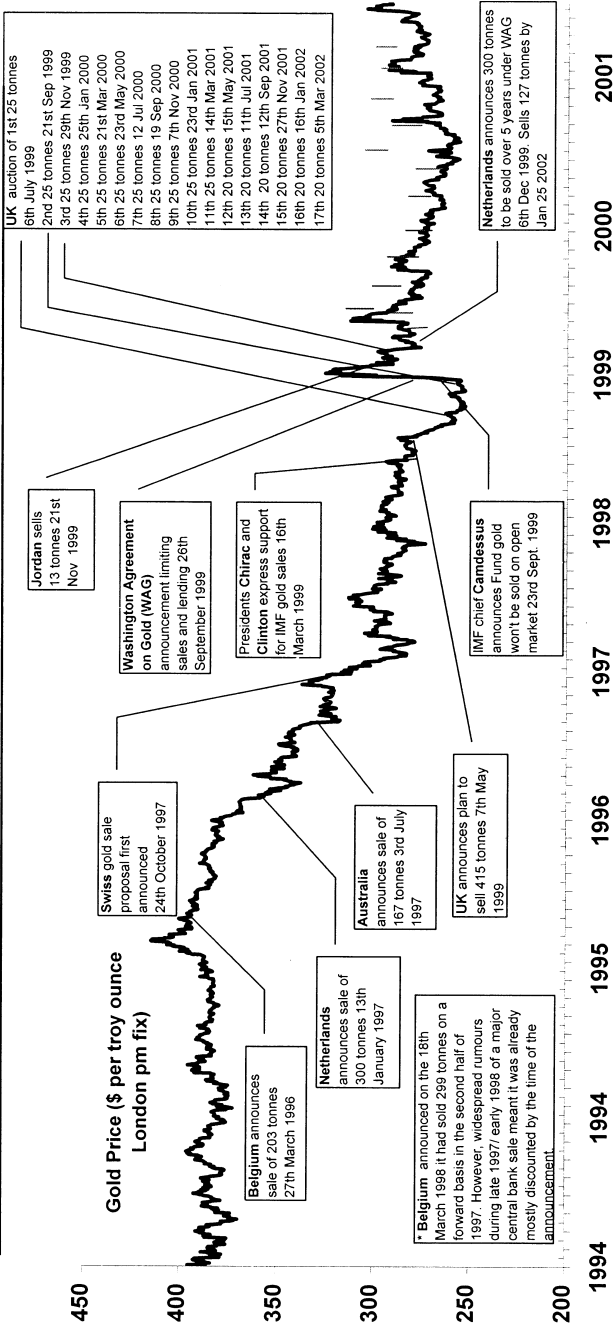
The dollar gold price has risen some 40% from its low point in 1999; the rise in the sterling price is about the same. The charts overleaf illustrate recent developments. Among the factors that have been mentioned by analysts:

- the fall in the dollar and sterling against the euro
- the huge US payments deficit
- a growing threat of war in Iraq
- covering of short positions
- reduction of hedging by producers
- declining mine production
- investment demand
- speculators taking long positions
- zero or negligible interest rates in some currencies, which reduce the opportunity cost of holding gold
- growing confidence that central bank sales will be limited

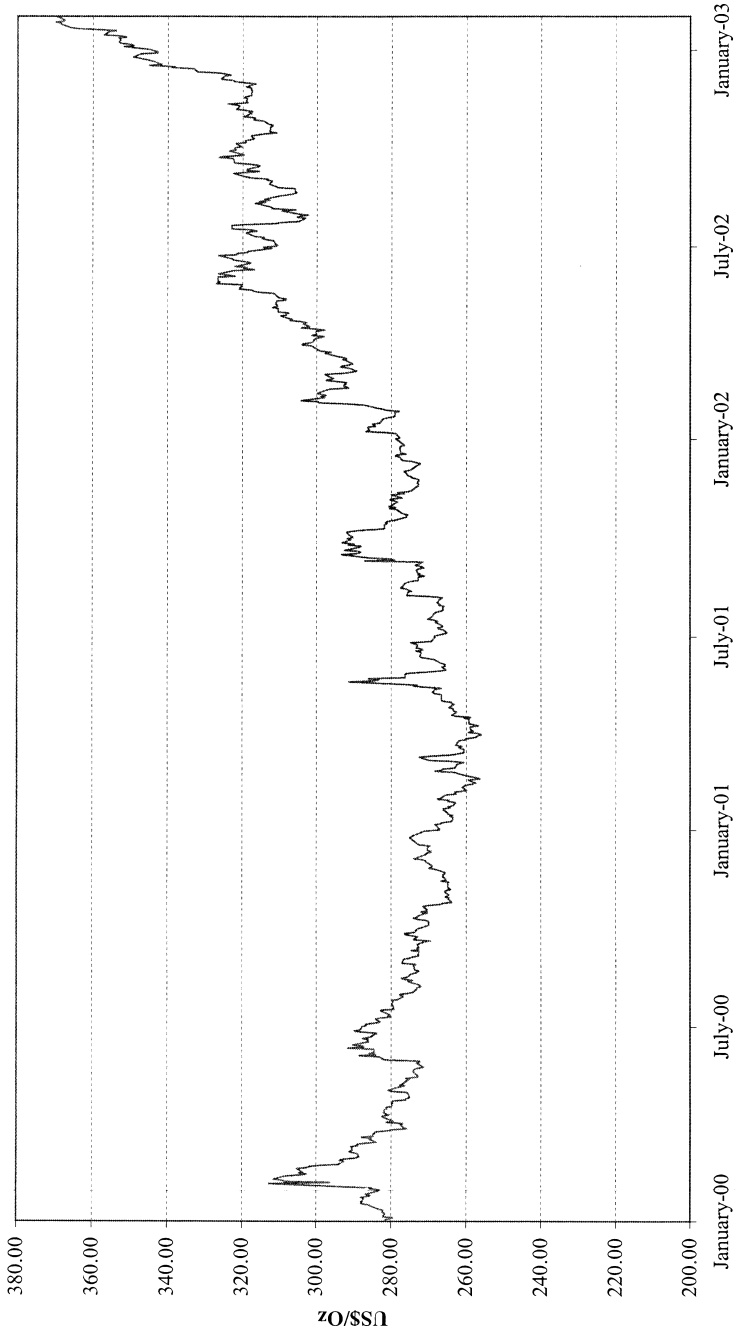
Probably, all these have played a role, more than offsetting the weakness in fabrication demand. What is not clear yet is whether the price movement has been merely bringing gold back to (or closer to) its long-term purchasing power level or whether it is signalling a possible future inflationary threat. That will depend crucially on how central banks handle the current challenges they confront.

Gold Price 1994-2002

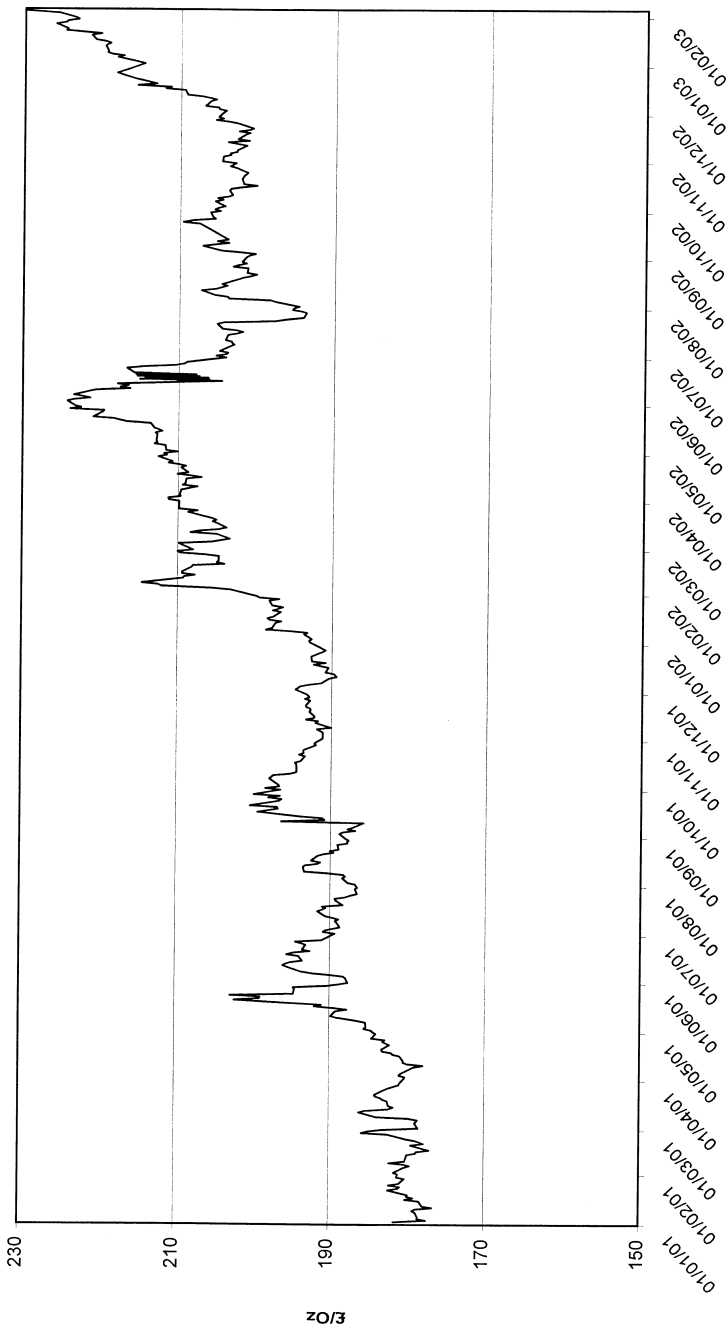
UK Auction: 25 tonnes | UK Auction: 20 tonnes



London PM Fix



The price of Gold in £



Role of central banks in the current environment

Although the world is not in deflation, there are many downside risks. There is a possibility of further stock market falls; banking failures; exchange rates swings – the rise in euro is deflationary for the euro area; the effect of war uncertainty on personal and business confidence; personal and business debts. Some say that the level of global risk is higher than at any time since the second world war.

Let us look at what central bankers have been saying:

Alan Greenspan (December 19, 2002):

Although the US economy has largely escaped any deflation since World War II, there are some well-founded reasons to presume that deflation is more of a threat to economic growth than is inflation....

One also should not overstate the difficulties posed for monetary policy by the zero bound on interest rates and nominal wage inflexibility even in the absence of faster productivity growth. The expansion of the monetary base can proceed even if overnight rates are driven to their zero lower bound. The Federal Reserve has authority to purchase Treasury securities of any maturity and indeed already purchases such securities as part of its procedures to keep the overnight rate at its desired level....

Greenspan concluded:

Clearly, it would be desirable to avoid deflation. But if deflation were to develop, options for an aggressive monetary policy response are available.

Professor Bernanke, an academic economist who is also a governor of the Federal Reserve, has insisted that central banks can always deal with deflation (falling prices). Significantly, he used the analogy of gold to illustrate his point – gold, the ultimate standard.

Like gold, US dollars have value only to the extent that they are strictly limited in supply. But the US government has a technology, called a printing press (or, today, its electronic equivalent) that allows it to produce as many US dollars as it wishes at essentially no cost. By increasing the number of US dollars in circulation, or even by credibly

threatening to do so, the US government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

The US government has a technology, called a printing press....

Wow! So did the German government after World War I, or the Chinese government after World War II – they also had that technology, the printing press, and used it to produce hyperinflation – no problem at all.

My conclusion from reading such passages as these and listening to their testimony is simple: central bankers are very concerned about deflation. They have become haunted by the spectre of the Great Depression which, as Professor Allan Meltzer has documented again in his recent monumental *History of the Federal Reserve*, was caused largely by the Fed's failure to maintain the money supply:

If the Fed had maintained monetary growth (in 1929-31) the country and the world would have avoided years of depression.

(History of the Federal Reserve: Vol 1, 1913-1951, by Allan Meltzer, University of Chicago Press)

What are the central banks doing about this?

In the US and UK they are following a pro-active policy of cutting interest rates, and relaxing monetary policy to sustain consumption. The European Central Bank has not been willing to be as pro-active. This is because the ECB, like the Bank of Japan, believes it is primarily structural problems that are causing economic difficulties and unemployment, not monetary policy. So they are trying to force politicians to act.

They are saying, in effect, 'you politicians must get your act together on reforming the economy's many rigidities (labour laws etc) before we, the central bankers, can feel able to act on interest rates or further expansion of the supply of money'.

In my view, this is a risky game to play, and the markets have reacted very unfavourably to it.

Right now, markets are not confident that the central banks can cope adequately with this new situation. The credibility that the central banks

built up during their victory over inflation is now at stake. There are many people ready to blame them. Investors have already lost massively. There is a desperate search to preserve wealth, with growing worries about deteriorating asset quality. These are classic signs of deflation following a speculative bubble.

This has happened many times before in history, often when inflation as measured by the cost of living is itself at low level. Initially, people find refuge in cash – bank deposits or paper money. But then people ask: are even these safe, when prominent central bankers are saying they could print money in large amounts and implying that they may do so in order to fend off the greater evil of deflation? How safe is the banking system itself?

It is not safe to keep cash if you think monetary policy might end up producing inflation – as the only way to get out of deflation. It has not come to that yet. But investors are starting to fear it: central banks might be forced to flood the system with liquidity in a bid to avoid deflation. Prominent central bankers are already talking saying they have the technology to do this. So gold is again recovering its classic role.

Central banks' activities in the gold market

Central banks affect the gold price in two main ways: first, their monetary policies determine price rises or falls and thus the nominal price of gold; each individual national central bank in effect sets the nominal price of gold in its own currency by its monetary policies; second, their sales and lending of gold from their stocks (minus the occasional purchase of gold) have a direct impact on the current supply/demand balance in the gold market.

In the current phase (starting in the mid 1990s) the official sector is a large net supplier of gold to the markets. However, the rising trend of sales and lending was stopped by the central bank agreement of 1999. Some sales are expected to continue for another few years. But the gold will be brought to the market in a controlled and responsible way.

Moreover, Europe may not be a big seller for the long term. The US confrontation with France and Germany over Mid-East policy has reinforced the European determination to assert their independence and freedom of action. In these circumstances, to sell gold and get more dollars would be to finance a war they do not believe in and make their economic policies hostage to the United States.

Conclusion

The world economy is teetering on the edge of a deflation – stagnant economic activity with flat or even declining price levels. It is not a question of a return to the 1930s – thankfully, that is not on the cards. But economies have not adjusted to the excesses of the 1990s, downside risks are accumulating and, despite their assurances, central bankers cannot be sure they can deal with this situation. All this is quite new.

Despite deflationary tendencies, the price of gold has been on a rising trend (normally a signal of coming inflation). This is partly because the forces that had previously been depressing the price have gone away, but partly because new forces have come into play: first, gold is reasserting its classic role as a refuge against systemic financial strains; second, markets can smell a whiff of fear from central banks and know that they only have one weapon – to turn on the printing presses; third, central bank gold sales will continue to be handled in a way that does not disrupt the market.

The longer term future of the gold price depends now crucially on the central banks. Gold will continue to perform its classic roles. If central banks resort to inflationary financing, the gold price will continue on an upward trend. Purchasing gold remains one of the best means of protecting the investor against a wide variety of risks.

I would like to conclude with a quote from an article I read recently in the *Wall Street Journal* (December 30, 2002). It is by Mr Jason Goodwin, who has written a book called ‘Greenback: The Almighty Dollar and the Invention of America’, published by Henry Holt. I have not yet read this book or met Mr Goodwin but I would like to do both. Mr Goodwin starts the Op-Ed piece by reminding us of what former US President Hoover said about gold:

‘We have gold’, Herbert Hoover explained to his successor FDR, ‘because we can’t trust governments.’

Then, after a brief tour of US monetary history, Mr Goodwin concludes as follows:

Gold will always be part of the mystery of money. Just as it’s good for our souls, once in a while, to keep warm around a log fire, or settle down with a good old-fashioned book, so gold can never disappear, because it’s an eternal, disinterested witness to the tragicomedy of human history.

To which I say: ‘Here, here’.

IS THE 'RIGHT' ON THE RISE IN EUROPE?

Extracts from a talk given by Mr Robin Oakley, European Political Editor for CNN, to members of the Economic Research Council on Wednesday 25th September 2002.

Robin Oakley prefaced his talk with some comments on the (then) recent election in Germany won by Gerhard Schroder's 'red-green' coalition. He noted that Schroder's campaign had been helped by his handling of the recent floods, by the 'man of the people' image that he projected and by opposition to war against Iraq. His opponent, Edmund Stoiber, perhaps lost because of the 'Bavarian factor', because his coalition partners made some unfortunate remarks, because he personally lacked popular appeal and because his promise to cut unemployment by one million somehow lacked credibility. Neither side had offered 'Margaret Thatcher style' free market reforms.

Europe and the USA

In my role for CNN I'm beginning to get slightly embarrassed by the number of reports that I've had to do saying 'Europe is furious with the US over this, Europe is furious with the US over that' because on one issue after another multilateral Europe is finding itself at odds with a unilateral United States: Kyoto on global warming; the International Criminal Court; the scrapping of the UN Convention on Biological and Chemical Warfare; the steel tariffs imposed by George Bush. And of course the big tension between Europe and the United States on the question of Israel and the Palestinians in which there is a great feeling across an awful lot of European capitals that the US is much too one-sided, much too uncritical of Israel and not using its strength with Israel to help to push it in the right direction towards some sort of accommodation. There is a basic difference here that the Israelis do have great strength in American politics and America is Israel's biggest funder whilst I understand that the European Union is the biggest funder of the Palestinian Authority. At the same time the US is preoccupied with what they regard as a namby pamby Europe that won't spend what it should do on defence and won't make its proper contributions through NATO.

Germany and France

As you all know, it traditionally used to be that the Franco/German motor probably kept the Europe project ticking along. But that doesn't work with

Schroder and Chirac. In recent elections Schroder has backed Lionel Jospin, the Socialist opponent to Chirac in France whilst Chirac backed Stoiber (and gave him a Légion d'honneur) in the German election. And it was probably partly intended as a snub to Chirac that Schroder came to London rather than Paris for his first post-election meeting. France preferred Stoiber over Schroder in its efforts to avoid major reforms of the Common Agricultural Policy and Schroder is still smarting over Chirac getting one over on him at the recent Nice summit when he had made some concessions and he thought there were going to be concessions from Chirac on the CAP in return, but there were none. You know, it's just like kids in the playground really – and don't tell me that politicians don't behave in that way!

A rise of the Right across Europe?

A little while ago it looked as if there was a rise of the Right across Europe. Now, not only have Social Democrats held on in both Germany and Sweden but the picture is confused elsewhere as well. If you look at the track record of elections over the last couple of years in Austria, Italy, Portugal, France, the Netherlands and Denmark, you can say that there have been advances for the Right – whether it's a centre-Right or the far Right in all of those countries. But many of these moves are unconvincing. In Portugal it is more of a 'cock-up' by the left, in Denmark more often depends on personalities than on policies and in Austria Jorg Heider won't even stand for leadership of his collapsing party.

In France there was huge excitement over the so-called 'march of the far Right' when Jean-Marie Le Pen came second in the first round of the Presidential election. It was then presented as a triumph for the centre Right when Chirac won all but 18 per cent in the second round of the Presidential election and his party went on to win the Parliamentary elections. But remember that Chirac, this supposed triumph of Chirac, got, in the first round, the lowest vote ever for any incumbent President. Many people went to the polls in the second round under the slogan 'vote for the crook, not for the racist'. It was hardly a personal triumph. Le Pen did well in that first round for a variety of reasons – Lionel Jospin was an uncharismatic campaigner, the Left were splintered among a whole range of parties, the cohabitation of a Socialist Prime Minister and a Conservative President left people uncertain as to how to vote against the existing order and the French system gives a huge temptation, at least in the first round,

to voters to make a protest vote by voting for an extreme party. All the major parties seemed to be covering the same centre ground and there was also, I think, a huge mood of people being fed up with a kind of technocratic political class they felt were out of kilter with their lives – a growing problem perhaps, for politicians all over the place.

In the Netherlands the Christian Democrats have been returned. But Labour in the Netherlands was a tired old party running out of ideas and hit at the time by the scandal of what happened in the Balkans a while before with Dutch troops not doing enough to prevent it. All the energy in that election was really provided by Pim Fortuyn and his party who, though having strong policies on immigration, asserted that they were not a party of the Right. Part of their support was a sympathy vote for Pim Fortuyn's murder and as one message on the flowers piled up where he was killed read 'hated by many, loved by few, but respected by all'. He was a flamboyant character who was articulating some genuine worries and fears, and people liked his style – so different from the normal rather staid style of Dutch politics. So again I don't think it's something that you could say was part of a wider sweep to the Right across Europe.

Left and right – a picture of confusion

So I doubt if all this amounts to a swing to the Right across Europe. For a start there is not much evidence for one in the UK, is there? All the old Right-wing/Left-wing classifications are breaking down – politics is becoming less tribal and less ideological – more a contest of 'we will manage it better than the last lot did'.

In Germany parties of the 'Right' were usually at least mildly euro-sceptic but it was Schroder who was bashing the European Commission on various issues and Stoiber who was saying 'well the CAP may not need all that much reform'. It was Stoiber who was explicit in opposing, as he put it, 'US style hire and fire labour market reforms' and it was Schroder who had begun cutting taxes, reforming pensions and trimming state spending in order to keep out of trouble with the European Commission. Both the SPD and the CSU/CDU alliance are essentially corporatists who believe in state intervention and regard any real social market reform programme as a step too far for the very security conscious, safety conscious German society.

In Scandinavia, woe betide the politician from Left or Right who wants to whittle down the welfare state to any significant degree, and, whilst

many there call for immigrants to sit language tests to qualify for citizenship, they also recognise the need for a massive boost in immigration to help provide growth in the economy and a stronger social security base.

And anyway, in Left/Right terms, how can one assess Europe's often confusing differences with George Bush's version of a Right wing America?

The new rules

So all of this presents a picture of confusion, but, thinking about it, I suppose the key rules now seem to be: i) Yes, it's the economy stupid – unless you've got a very good diversion, ii) In an age of media dominated politics charisma counts – the less like a politician you look these days, the more the public are going to warm to you, iii) There's always a few votes out there for people who want to play populist games and flash the race card – but it doesn't guarantee success, iv) A little whiff of Euro-scepticism on the whole doesn't do campaigners any harm, and v) If you live in a coalition system pick your partners with care'

WHY A PROBLEM ABOUT PENSIONS?

By Brian Lewis

The BBC recently had an explanation for why pension funds were in such difficulty with resources suddenly and unexpectedly plunging and unable to meet obligations. It was said that the reason was that share values had dropped drastically over the last three years! I have seldom heard so asinine and fatuous a rationale for events that in fact require complicated, delicate and long-term analysis skills. It is of course now true that the financial community only likes to comment on what has happened yesterday and what may happen tomorrow, and expresses surprise when events conspire to overturn the general consensus and forecast. Clearly the financial community sees itself helpless in the hands of a suddenly vengeful and incomprehensible God! We surely cannot leave the matter at that or agree that the financial world was unaware of its forty year responsibility.

We need to consider what happens to contributions made to pension

funds over this 40 years by both companies and employees. Let us consider a new technology company starting today employing people in their twenties, and then that this company survives for another 40 years. It then has to start paying out the agreed pensions to those first employees, who are now 65 years old. It is clear that the company is responsible for accumulating a large capital sum over this 40 years from contributions, and that this is known over a very long period of time. Over 40 years, invested wisely, receiving interest and dividends, a very large sum of money comes into existence. The main question is, who controls this money and is it in safe hands? Can those responsible be trusted?

There were times long ago when any questions about a pension fund were fobbed off by reassuring statements that the company was responsible, and would guarantee any shortfall. Nobody asked who would be in charge 40 years hence. I myself was also to a great measure heartened to hear that the matter lay in the hands of wizards, called actuaries, who would year by year readjust the capital required to meet the pension payment obligations. The very fact that any question related to events a distant time into the future made it difficult to enquire further.

One legal factor that weighs heavily on what happens to pension funds is that the pension fund belongs to the company, and not to the pensioners. As long as resources exist to pay all pensions, there is no worry, but has the pensioner any legal rights at all? For very many years up to 1999, no one felt it necessary to disbelieve what they were told. But recent events seem to contradict this faith in the system. In the first place, investments fluctuate over many years – that 40 year period – so in some years investments will do marvellously well, and in others quite badly. This is well-known, and major stock exchange fluctuations cannot have come as a surprise to pension fund managers. I assume the actuary also keeps an eye on all of this. Yet I now see that actuaries are human like the rest of us and have feet of clay; like the rest of us they are subject to worldly temptations, eager to meet the wishes of the people who pay them.

The stock exchanges of the world have done well over many years up to 1999, giving very large capital gains to pension fund investments. The pension fund managers and advisers over these long years seem to claim this bonanza came from their special expertise! So well did they do in fact, that companies were able to suspend contributions to pension funds because the asset ratios of income to pension payments were so favourable. Companies asked for and got ‘contribution holidays’, which were greatly to the advantage of shareholders. But we must now ask where that money

saved went to? Companies are rather shy to answer this question, but it appears that companies used this money, obtained from pension contribution holidays, to boost investment and give their shareholders a better profit (either as a dividend or capital gain on their shares). We might ask at this point how it is possible for a company to complain at recent falls in stock values, when huge sums were saved in earlier years by not having to contribute to the pension fund. By act of Parliament, it is clear that a pensioner had no legal say on whether ‘contribution holidays’ could take place or not. Legally it was not pension money and pensioners had no rights. One might wonder whether a company did not have a moral obligation to save money from ‘contribution holidays’ in case actuarially shortfalls occurred sometime later in that 40 year period!

We turn to the actuaries! It is very clear that he or she, as an actuary and pension fund manager, must anticipate very large fluctuations in investment values likely over that 40 year period before an employee retires. Life is after all very long, and full of crises and exigencies. We might expect long periods when the share values are far below long term trend lines, but also years when they are way above. He or she might also anticipate unforeseen political, social and economic upheavals over 40 years, which would need contingency factors to be built in to forecasts to ensure a pension gets paid. I know this, although I have no financial or actuarial training. But isn't this what *actuaries* were employed to do? Recently actuaries have been conspicuous by their absence. It now looks as if I understood more about the world than they did!

Governments also provide pensions to the old and infirm. I seem to remember that when I was 18 in 1952, the British Government was promising to look after me in old age. I am near 70, but the government is now changing the rules! Who was I at 18 to have doubts about what our government and politicians promised. In fact wherever I was in the world, I always religiously paid my contribution to my old age pension, and now receive a sum, which seems to change with the prevailing political wind. It is disquieting in old age to be told that all my contributions were spent long ago in a ‘pay as you go’ social security system, which accumulates no assets. It is confusing to say the least to be told that there are not enough young people around to pay the pensions of the old when the old have contributed all their lives (and quite often been denied the right to work after the age of 50). I am not really sure why the facts of the case were never pointed out to me before I was too old to arrange to look after myself. It is with even more bafflement that I read that I can expect inflation adjustments to

my pension if I live in Spain or the Philippines, but no inflation adjustments if I live in Australia or Canada! Has there been a recent realignment of international relationships that has escaped me? Perhaps it would have been more prudent in 1952 to have been told to look after myself.

That also raises the question of currencies and inflation in relation to pensions! Companies receive money in today's money, but pay out pensions in the devalued money-of-the-day forty years later, usually in the currency of the country of origin of the employee. That may be more to the advantage of the shareholder than the employee! Governments blithely operate in their own national currencies, and politicians often assume that a pound sterling in 1945 was much the same as in 2002. International companies often operate a PPP – purchasing power parity – system in comparing one country to another. Perhaps governments need to guarantee a PPP pension – rent, one sack of potatoes and a side of roast beef every month for each pensioner. But I fear we now have to admit that politicians do not operate over 40 year periods, and we all need to look to our own interests by having a nest-egg separate from political control.

There is also the question of a collapse in financial ethics and general social morality. Has this changed in the last 40 years? Are we perhaps in difficulties because for many people in authority 'my word is my bond' no longer has much meaning. Get in and out for a quick profit, that's what counts today – not how you got the money. It has generally been recognized that this has become more and more applicable to politicians, who are very low on the rungs of the ladder of confidence. But have we fully understood that those in charge of our assets no longer feel any great responsibility for safeguarding what is not theirs. Companies have been reported to be using their employees' pension funds today as a useful pot of money to boost profitability and investment at the expense of some poor employee in 40 years' time. One suspects in the modern world this is being done without a qualm of conscience.

Perhaps the world has always been like this! Where money is concerned there are no ethical considerations! But one cannot help notice that failure is greatly rewarded in modern times, as senior executives – richly rewarded – depart riding over the ruin of their shareholders hopes. Financial failures and their families depart with millions in the bank to take up their position in society amongst the great and the good. Money talks. But it is our money talking, not theirs. I saw an interview the other day where an executive of a dot com company at the height of its success, resigned with all his stock options at maximum value, three years before complete collapse.

Good financial judgment! He bought himself a vineyard and lives well. He got out then, because as an insider and an intelligent man, he could see what was going to happen! He sounded very pleased with himself, and clearly had no qualms or sympathy for those who lost everything in the final debacle. The problem is that these men with their bank accounts are the new leaders of society!

Where pensions are concerned there must be a system in place, that recognises that handling money and financial trends over 40 years is fraught with difficulty. It cannot be a question of simply playing share markets without regard to long-term risk. Some degree of safety must be built in by law. Companies cannot be allowed to use pension funds for short-term enhancement of share values or profitability. Perhaps above all we still need to decide who owns the pension fund, and put legal brakes on what short-term decisions are allowed. At first sight it seems obvious that it should be the pensioners who own the pension fund – but who are they; the eighty year old pensioner about to die with 50 years service or the new recruit with two years' service? But at the moment it is the company and its senior executives that control the pension fund, irrespective of what contributions are made by employees. In a world without moral standards, this puts too much temptation into the hands of senior executives.

Even governments have begun putting their fingers in the honey-pot of pension money. What guarantee is there that this will not continue? Perhaps mankind being what it is, in the end there can be no guarantees of pension value for 40 years ahead. 'O put not your trust in princes, nor in any child of man: for there is no help in them.'

We still need a system whereby there is greater transparency on who owns a pension fund, and who controls it.

At present there is growing misrule, confusion, perplexity and turmoil, which suggests that we have reached a situation where there can be little confidence that pensions will be paid in 40 years' time, and still maintain their value. The reply might be that life is always uncertain and there is no remedy.

It should not be beyond our ingenuity to devise a legal framework that defines the relationship on controlling pension assets precisely between the employee, pensioner and the company over the full forty years of this crucial relationship, upon which the long term well-being and stability of modern society actually depends.

THE BEAR WENT TO THE TOP OF THE MOUNTAIN

*By Saker A. Nusseibeh**

When I started my career, I was privileged to have my desk next to a legendary fund manager in the UK called James D'Albiac. He had changed careers from brokerage to fund management in 1973. He had also made his personal fortune by investing heavily in equities at the bottom of the bear market in that year. As he tried to explain to me the psychology of a true bear market during the bull market of the late 1980s, he showed me the last general market letter he had written as a broker before he chucked it in and became a fund manager. In bold type, it stated at the top of the letter fund managers must remember that share prices have the capability to go up as well as down.

As I survey the situation in world equity markets today, and listen to the views of fellow professionals, I often think back to my conversations with James. I try to see the extent of parallels, if any, with the famous, or should one say, infamous, bear market of the 1970s. I have also been thinking, as have many of my fellow money managers, of parallels with other bear markets.

There are clearly some similarities. World equity markets have fallen by around 50% since the peak of the bull market. According to data from Crandall, Pierce & Company, this is of a magnitude equivalent to the worst declines in all bear markets over the previous century, with the exception of the 1929–1932 collapse. In terms of longevity, there have been three longer lasting bear markets (1909–1915, 1937–1942 and 1966–1970). However, the current bear market has lasted longer than the average of bear markets in the 20th century (23 months).

There are, however, important differences between the current bear market and those in the past. Two perhaps are worth touching on, as I believe them to be connected. The first is the issue of valuation. Despite the steep falls seen in world equity markets, valuations are still not as cheap as they were, say, at the bottom of the 1973 bear market. Secondly, although we are all aware of the war risk premium, the nature of this risk is fundamentally different from the risk premium inherent in all post-1945 bear markets. Between 1945 and the fall of the Soviet system, whenever

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political concerns helped fuel bear markets, the risk being discounted was that of a war between two superpowers, the outcome of which was never certain. The current impending war is between the world's greatest military power and a tin pot dictator with an ill equipped army that essentially fled the field the last time it faced the US. The outcome, therefore, is assured, even if some complications might arise out of this conflict, including increased incidence of terrorism or possibly a short-term spike in oil prices.

A third factor that is much harder to assess is the role of central banks. Clearly, the 1929 crisis was exacerbated by a flawed understanding of economics and the resulting deflationary policies pursued by the authorities. To some extent, the 1990s bear market and deflationary economic situation in Japan can also be blamed, in part, on mistaken policies in the first stages of that market's collapse, and more recently, by an inability to instigate structural reform. One's working assumption is that the Western authorities are likely to pursue more sensible policies. That certainly seems to be the case in the US, although there are times when investors have questioned the wisdom of the ECB's policies or the willingness of mainland European governments to instigate structural reform.

One of the main differences between the current and previous bear markets is the undoubted effects of the technological revolution. It is now widely accepted that technology has led to a permanent step up in productivity. However, it has other wider implications. For example, I would argue that the risk of an inflationary shock induced by an oil price hike (similar to what the world saw in the 1970s) has been much reduced because advances in technology have allowed oil companies to discover many more reserves. Thus the world reserve of oil today is substantially higher than what was believed to be the case in the 1970s (1tr bls of proven reserves and up to 3tr bls of potential reserves¹). What is more, it is cheaper to extract and we are more energy efficient today than we were in the 1970s (\$1500 worth of output per barrel in the US against \$750 in the 1970s).

Technology has also changed the nature of companies. It was fashionable for radical university students to talk of the world being controlled by multi-nationals in the late 1970s. At the time, that was pure hokum. I know, because I was one of those who expounded (and honestly believed) such views. Today, I think that student view has a greater factual basis, although with a different slant. Companies have production capabilities all

1. Carey, J. 2003. 'Taming the Oil Beast.' Business Week – European Edition (February 24): page 48.

over the globe, often linked electronically in real time. The products of those companies are so interlinked with other similar global companies that it becomes hard to isolate them within defined geographical regions. For example, the Dutch company ASML, one of the world's leading manufacturers of steppers (the machines that make silicon chips) is quoted on the Amsterdam Stock Exchange, but has major production facilities in California. It is linked to the semiconductor makers both in the US and the Far East and ultimately to consumers of electronic goods in every country in the world. Clearly, this is neither a Dutch nor a European company, other than in terms of the location of its quote, but rather a global company in terms of economic reach and exposure.

This tilt towards value-added from knowledge-based rather than manufacturing-based production has also changed the way in which one looks at companies in emerging markets. Do we look at Infosys Technologies as an Indian company subject to emerging markets dynamics or as a software company, and so subject to the dynamics of the global software market?

Nor are these profound changes in the way one perceives companies limited only to technology-related companies. When I dial a national free phone number to a call centre from my home, I am connected to a helpful, educated, English-speaking operator. What I do not realize is that as often as not, that operator is not located in the UK, where I live, but probably somewhere in the Indian sub-continent, some five thousand miles away. Thus, the financial services company that I use has part of its 'service' facilities in India!

These changes are also important for the way we invest. In the past, the main argument for investing outside the US was diversification. As globalization gradually tied the major global and multi-national companies ever closer in inter-dependence, the correlation of stock prices worldwide (with the exception of domestic value stocks in Japan) negated the diversification argument. However, that trend does not negate the need to invest outside the US. On the contrary, I would strongly argue that globalization has increased the need to invest outside the US, but on an entirely different basis. Moreover, I would strongly argue that it has changed the way in which investment outside the US should be conducted.

Globalization is leading to a situation where the leaders commercially are not confined to one geographical region. The fact that Intel is quoted in the US is secondary to the fact that it is one of the leading semiconductor manufacturers worldwide. For a non-US investor, buying Intel stock is not

a call on the US market, but a way in which to gain exposure to the world leader in that space. The same argument applies, in reverse, to a US investor. SAP is one of the leading business software companies worldwide. A US-based investor would buy SAP, not to gain exposure to the German market, but to gain exposure to a leader in that part of the global economy. This extends beyond technology. BMW is primarily a leader in the luxury car market, rather than a way to gain exposure to Germany; Total is primarily one of the leaders in the oil industry, rather than a way to gain exposure to France.

Further, this has extended to investment in emerging markets. It is true that Samsung still suffers from the ‘Korea discount’ effect, but in reality, its economic make-up and exposure is global. An investor should buy Samsung, not as an emerging market, or a Korean play, but in order to gain exposure to a world leader within its segment. The same argument applies to Teva in Israel, or to Infosys Technologies in India.

It is my strongly held belief that as a result of the economic changes we have seen over the past two decades, both in terms of the technological revolution and globalisation, the world economy is dominated by a relatively small number of global leaders in various segments of industry. This group, a modern day ‘nifty fifty’, are partly quoted in the US and partly elsewhere. Therefore, a US investor needs to invest in these companies to ensure exposure to the potential returns from all of these global leaders. In other words, the argument for investing outside the US is one of exposure to a full opportunity set. Moreover, if one accepts the above argument, a non-US investment portfolio should be constructed purely on a bottom-up basis, because its aims are not geographical diversification, but rather, company specific exposure. This philosophy should apply equally to emerging and non-emerging markets.

If we now return to the subject I raised at the start of this article – equity markets are down some 50%, which is much higher than the average fall suffered in bear markets over the past hundred years. The fact that valuation remains robust can be explained by the twin factors of a return to the long-term low-inflationary environment, and the implications of the total political victory of the West. Of course, this weakness in equity markets can continue for some time, especially if we factor in anaemic economic growth, which will translate into anaemic earnings growth, at least for the next 12 months. Looking at my screen today, analysing the recent weak US consumer data, it is easy to believe that this bear market will continue for some time to come. However, as James pointed out to me all those years ago, the

definition of the pit of the bear market is that no one believes that share prices can rally.

So the question becomes, what happens when the bear market ends? Before I try to address that, I would like to point out some interesting research that Morgan Stanley published in January/February of this year.² They looked at the prices of companies in the European markets (defined as PERs), divided them into quintiles, and then traced their history back to the late 1980s. The research clearly shows that the PER spreads between the most and least expensive stocks have compressed in this bear market. At the same time, they divided the same companies into quintiles based on their Free Cash Flow/Sales and found that the spread between the best and worst cash generators has widened. In other words, investors are failing to discriminate between good and bad companies. Such an anomaly reflects a general, unthinking de-rating of a stock market typical at the last stages of a bear phase. I would argue strongly that this price differential is illogical and ought to reverse once markets rebound.

The other interesting piece of research they presented is about the out-performance of value stocks in relation to growth stocks. During this bear market Value has out-performed Growth by 90%, a degree of out-performance not seen since the mid 1970s. Again, I would argue that a reversion to the mean would lead to an out-performance of Growth in the upturn, a fact supported by their research into the recovery from the 1970s bear market.

It seems to me that we must be nearing the end of this bear phase, and I take heart from the despondency of my fellow equity investors. The bear market might last a while longer, but in terms of falls, it has matched all previous bear markets bar 1929. Once we do see a recovery, it seems reasonable to expect an out-performance of Growth, especially outside the US where Value's out-performance is at an extreme level (about three standard deviations). Further, given the profound and fundamental changes that technology and globalisation have brought about over the last two decades, the 'nifty fifty,' which normally leads a recovery from a bear market, is now composed of companies based all over the globe, not just the US, and they are trading globally. This new group will allow a new breed of international fund manager to out-perform; managers who would be investing on a purely bottom-up basis in 'the best companies in the world,'

2. January/February 2003, Morgan Stanley European Equity Markets Strategy Guide and Chartbook.

rather than trying to add value from asset allocation. In some ways, this is a return to the post-1973 bear market fund management, but this time on a global canvas.

EQUITY SHARES AND THE EURO

*The Slump in Equity Shares arises from Improved European
Self-Sufficiency coming with the euro*

By Peter L. Griffiths

Currency exchange rates and currency in circulation

The only way a devaluation gives rise to an increased circulation of the devalued currency is when the revalued currency is offered to the central bank issuing the devalued currency. This central bank then issues more of the devalued currency in exchange for the revalued currency.

Conversely the only way a revaluation gives rise to reduced notes in circulation occurs when the devalued currency is offered to the central bank issuing the revalued currency. This central bank then issues less of the revalued currency in exchange for the devalued currency .

On the whole there should be a tendency for the increased issue of the devalued currency by the devalued currency central bank to be offset by the reduced issue of the revalued currency by the revalued currency central bank.

Euros and the US Central Bank

It would seem that the US Central Bank has issued fewer dollars in exchange for euros offered, but that this has not been completely offset by the increased euros issued by the European Central Bank (ECB) in exchange for dollars offered. The ECB has concentrated on issuing euros in exchange for the former European currencies. The dollars offered to the ECB would continue to be regarded as being in circulation regardless of whether the ECB bought them or not. It looks as if dollars in circulation being offered to the ECB were being exchanged for more euros than was originally expected, whereas euros being offered to the US Central Bank were receiving fewer than expected dollars in exchange.

Reduces dollars in circulation caused the slump in US equity shares

The net result was reduced dollars in circulation which has caused the slump in US equity shares, but there has also been a small net increase of euros in circulation which has caused the rise of prices in Europe.

Improved European self-sufficiency has reduced US exports and reduced dollars in circulation

The question as to what has happened to the money that was paid to maintain the high prices of equity shares can be answered as follows. This money has been taken out of circulation by the US Central Bank reducing the dollars given either in exchange for euros offered or because euros have not been offered. The reason for this is that holders of euros, being foreign importers, did not want as many dollars as the previous holders of European currencies, because their demands would in future be satisfied by the European market. This would explain the declining US exports to the European countries since the introduction of the euro. Hence there has been less need for euros to be exchanged for dollars at the US Central Bank. Hence the circulation of dollars has been reduced with the result that fewer dollars have been available to purchase equity shares. This indicates that improved European self sufficiency has been the basic cause of the US slump in shares. Reduced exports give rise to reduced currency issued by the exporting country. Conversely increased exports are financed by increased currency in circulation issued by the exporting country to the foreign importer. Increased money to finance an equity share boom could therefore come from increased exports. This also answers the question as to why it is that internationally, equity share prices move together: they move together because the exports of all countries also tend to move together.

Increased price of gold

One other consequence of the improved self-sufficiency of Europe is that foreign purchasers of European goods and services will need to acquire gold to buy Europe's exports. This explains the recent increased price of gold.

Because of Europe's improved self-sufficiency the USA cannot export to Europe and therefore there is a decline in the circulation of the dollar

which reduces the price of US equity shares. The USA also cannot import from Europe unless it first purchases gold which raises the price of gold. It therefore follows that the reduced price of equity shares and the increased price of gold are the double consequence of improved European self-sufficiency arising from the introduction of the euro in place of the previous individual European currencies.

The cure

The question naturally arises as to what action if any should the UK government take to put a stop to declining prices of equity shares, particularly those shares acquired by pension funds without the clear consent of the pensioners. The cause of the price slump seems to be reduced money in circulation arising from reduced exports. The cure would seem to be increasing money in circulation without excessive price increases.

The impact on pension funds and the UK joining the euro

One of the most convincing arguments against the UK joining the euro was the impact expected on pension funds. Well, we have already suffered an impact without even joining!

One of the unforeseen consequences of the Iraq crisis could well be closer UK cooperation with Europe including the UK adopting the euro as its currency. The euros if slightly overissued in exchange for the pound could benefit UK equity shares insulated from United States' share movements.

THE EDWARD HOLLOWAY COLLECTION REVIEW

Deschooling Society by Ivan Illich *(Harmondsworth: Penguin, 1971)*

Ivan Illich, who was born in 1926 and died late last year, was a man of many parts. He was a dissident cleric whose faith, rather than doubt, led him to challenge the Catholic hierarchy. Transplanted as a young man from Vienna and Rome to New York, Puerto Rico and then Mexico, he straddled Old and New Worlds, over developed and 'developing' societies. A radical, who battled tirelessly and in practical ways for the poor, Illich was also

deeply conservative, championing such 'organic' experiences as friendship, conviviality and loyalty to local community, rather than grand design or abstract theory imposed in the name of progress or the greater good of man. Illich was an erudite man, but in his long writing career he gave an intellectual context to the instincts and insights of peasant societies. As such, Illich might have been a pioneer of the Green movement, had that movement genuinely transcended 'Left' and 'Right' wing labels, instead of turning into an encounter group for recycled *soixante-huitards*.

Illich might not have been a Green pioneer (and that was the Greens' loss not his), but in *Deschooling Society* he emerges as a prophet as well as a social chronicler. For he believed that mass education, far from being the harbinger of human progress, reason and opportunity, promised little more than a bureaucratic nightmare. Through mass schooling, and the emphasis on credentials and 'qualifications', valuable skills were being lost, communities broken down and individuals made more dependent on the state on the one hand and corporate consumer culture on the other. Modernist education, to Illich, was a poor substitute for traditional rites of passage for the young.

School is a ritual of initiation which introduces the neophyte to the sacred race of progressive consumption, a ritual of propitiation whose academic priests mediate between the faithful and the gods of privilege and power, a ritual of expiation which sacrifices its dropouts, branding them as scapegoats of underdevelopment. Even those who spend at best a few years in school – and this is the overwhelming majority in Latin America, Asia and Africa – learn to feel guilty because of their underconsumption of schooling.

These are harsh words, delivered with characteristic rhetorical flourish. But events have proved that Illich's thesis has more than an element of truth. In the 'developed' West, the narrow emphasis on academic qualifications has made schooling a miserable, rather than a fulfilling, experience for many young people. Studies of peripheral intellectual or cultural merit are elevated at the expense of craftsmanship and skill – domains of the increasingly marginalized artisan. Inventiveness and creativity are stifled, in favour of conformity and submissiveness. Accumulated wisdom is sacrificed, on the altar of approved 'knowledge'. The academic ideal itself suffers, because the academic curriculum is shorn of intellectual rigour to turn it into a product fit for mass consumption. To Illich, modern education is a game in which there are no winners, except bureaucrats and self-appointed experts.

There is more to schooling, of course, than Illich's bleak vision. However it would have been better if this little squib of a book had received more attention in its day, for it points towards some of the most dangerous and destructive educational trends. The Blair government's daft proposal that half the population should go to university would be recognised by Illich as the fulfilment of his worst prophecy. University is seen, in mystical terms, as an end in itself, whilst in the name of false 'equality', everything that makes university distinctive is undermined. Dumbed-down, mass access academia is complemented by a growing body of school refuseniks, young people Illich sees as rebels with a cause:

In fact, healthy students often redouble their resistance to teaching as they find themselves more comprehensively manipulated. This resistance is due to ... the fundamental idea common to all schools – the idea that one person's judgement should determine what and when another person must learn.

It would seem to follow from this that Illich would favour 'progressive' schooling, in the form of Summerhill-style experimental schools or non-competitive, mixed ability teaching in state education. But Illich sees such approaches as a chimera. To him the underlying problem is schooling itself and attempts to modify it or 'reform' it are doomed to failure. In this, too, he is prophetic. The progressive educational methods that were coming into vogue when *Deschooling Society* was written have since congealed into authoritarian dogmas, inimical to creativity and overtly hostile to traditional skills. An admirer of the co-operative, as opposed to centralising, strain of socialist thought, Illich sees schooling as the bureaucratic nationalisation of knowledge. His is a society of autodidacts, where knowledge comes from an infinite variety of sources, and where the transfer of skills between generations, and the apprentice-master relationship, are cherished rather than undermined. Paradoxically, these localised and highly specific forms education are broader in scope than the universalised approaches of modern schooling. They give back to intellectual creativity, as well as artisanship, the value that dumbed-down academic curricula take away. A deschooled society is a more culturally diverse society than one governed by paper qualifications.

Rising skill shortage, alongside the growth of boredom and disaffection in non-academic pupils (and burnout among their academic colleagues) show that Illich was right. For ERC members, the value of this book lies in his challenge to the idea that big is always better, that more expense always brings better results:

Educators can justify more expensive curricula on the basis of their observation that learning difficulties rise proportionately with the cost of the curriculum. This is an application of Parkinson's Law that work expands with the resources available to do it. The law can be verified at all levels of school: for instance, reading difficulties have been a major issue in French schools only since their per capita expenditures have approached US levels of 1950 – when reading difficulties became a major issue in US schools.

Mass education, mass politics and mass consumption are the models we continue to impose on the 'developing' world. By the 1970s, Illich was already aware that these models were false ones, founded on bad faith, that would increase the very iniquities they were intended to tackle. His ideas are, therefore, as relevant today as they were then. Indeed, it could be said that their moment has come.

A.R.

MODERN JAPAN – A SOCIAL AND POLITICAL HISTORY

*By Elise K Tipton, published by Nissan/Routledge 2002
ISBN 0-415-18537-8 (hbk) 0-415-18538-6 (pbk)*

This is indeed a very 'modern' history of Japan. There have, of course, been many books on Japan's history but the better texts are now ageing and there is a need for a re-interpretation linking the past to Japan's current social, economic and political difficulties. Elise Tipton has written a perceptive narrative bringing the picture – literally – up to 2001 (and it is a little un-nerving to read about events of only 12 months ago described in the assertive judgmental terms of the historian's past tense conclusions) on subjects as diverse as discrimination, domestic and international politics, economic malaise, and religion. Her text begins its journey in 16th century Tokugawa Japan and then the themes of greatest interest to her weave their way in and out of chapters and periods to arrive at a present thus made understandable through events and developments rather than through present day rationalisation. The reader is carried with interest, and with advantage, from cover to cover. This is a review which holds one's attention, contains a wealth of factual detail and, at some 250 pages, is a length accessible to a wide range of readers.

Whilst recognising the inclusiveness of this survey one is inevitably led into unanswered questions – departure points perhaps for an expanded later edition. For example, we are told that Japanese companies in the 1980s preferred to invest money in ‘Zai-tec’ rather than pay higher wages (or for that matter higher dividends or lower prices). Clues are given, such as the end of trust-busting in the 1950s, but one is left asking why? How come? We are told that Christianity has little appeal to Japanese. Again – why? What strange psychology and alchemy makes the Japanese so different in this respect to their neighbours in Korea? Then we are told that there is no Shinto philosophy. Indeed there is not. But why? What is the underlying difference between religions asserting philosophy (such as Christianity) and one which offers only such vague notions as ‘the way of the gods’ or the ‘spirit of Japan’? And so many other questions – is it not extraordinary that Japan has developed so far in areas such as art, etiquette, miniaturisation and ritual and yet has contributed so little in music or literature? Why is an underlying theme in foreign relations so often seen to be paranoia? How does this relate to the sense of relief upon defeat in 1945, positive acceptance of the occupation forces and now a continued clinging to pacifism?

On one subject however, this book is determined to leave no stone unturned and no reference ignored. This is the subject of the rights, role and status of women. This is taken so far that it becomes an annoying obsession detracting from, rather than enhancing, the value of the book. To be told that in the 19th century women in Japan were paid less than men or were less likely to be educated, feels not so much like the presentation of surprising information as like advocacy building blocks. Whilst there is a great deal of useful information about Japanese women it seems irritating (and the reader learns to cynically predict this point) to have so many passages talking about discrimination against minorities (Burakumin, Ainu, Koreans, recent immigrants, returnees – but not, incidentally, gays) immediately followed by a link with women. For example, on page 211 we read ‘The old minorities of Koreans and Burakumin perhaps continued their slow improvement, but the working conditions and social position of women, Okinawans and new minorities remained the same if not worse’.

The facts are not at issue. In Japan, women are paid less than men; they occupy fewer corporate and political positions and live in a society which holds many old fashioned notions about gender roles. The problem is perspective and proportion.

Linking ‘women’ to ‘minorities’ seems odd when each of these minority groups are of two or three million whilst ‘women’ are more numerous than

men. Then there is the curious phenomenon of a large number of post child-rearing married women, not seeking to be employed and able to spend their husbands' salaries as they wish, who seem more like a new leisured aristocracy than an exploited class. Further, there needs to be an understanding of the suffocating and overwhelming power of the Japanese woman within the home. A Japanese academic colleague (an author of a previous book in this Nissan/Routledge series) told me of his humiliation one day on arriving home to find that his wife and mother had decided to have their house demolished, had chosen the new design and had awarded the building contract. This was the first he had heard of it! Japanese children learn from the start that having Dad on one's side counts for nothing if mum wishes the opposite. If rights are to be seen of male to female relationships then, whilst in the West women may need institutional assistance, in Japan one often has the intuitive feeling that something needs to be done to bolster the confidence of so many apparently weak-minded males. In Japan it may be true that, on balance, a woman's lot is not so very happy but we should take care before concluding that a man's lot is any better. So the treatment of this subject in Tipton's *Modern Japan* seems a picture seen through western eyes, through current political correctness and with an agenda for change here rather than there.

This obsession aside, *Modern Japan* is a joy and a help on so many issues. It is valuable to learn of the reasons why Marxism has failed to make a greater impact; it is fascinating to have sample character studies to show the role of ex-Samurai leaders during the Meiji reforms. There are excellent passages explaining how individualism in Japan is easily misinterpreted and often despised. Students of political 'spin' will chuckle to see how reactionary policies can be portrayed as the 'correction of excess'. It is time to do as this author has, to include fresh information about the appalling war-time use of 'comfort women'. There is certainly sufficient account of developments amongst such groups as the Burakumin and the Koreans for the reader to feel well informed without having to turn to specialist texts. There are excellent accounts of the events leading up to the war, the war itself and its aftermath which demonstrate the interpretive maturity now possible half a century later. Chapter 4 'The 1880s and 1890s: defining a Japanese national identity', I noted as 'a gem' whilst the final chapter entitled 'The last decade' I noted as 'Heroic, well done – and an assessment which may well be right'.

J.B.

LETTER

A Response to 'Aspects of Fair Trade and Giving to Charities' by Mr John Whitaker, from Dr Bernard A. Jubby, former Trade and Industry Spokesman, Federation of Small Businesses

Dear Sir,

It is a trifle rich of Mr. Whitaker to talk of 'Unfair trade' vis-a-vis charities (B&O Autumn 2002, Vol.32, No. 4) when most charities running retail outlets should practise what they preach.

With many charity shops operating a buy in to sell policy while benefiting from favourable rates reductions (often 100%) and taxation treatment and 'employing' much voluntary work they are undercutting bona fide retailers who sell the same products yet are saddled by rates, taxes and all the employment legislation that goes with it.

Faced by this unfair competition many small shops have actually gone under as a result. There was even the instance of a cafe opposite a church organisation offering a counselling service whose tea and biscuits provision during counselling expanded into a full-blown cafe and take-away. Where was the charity in putting a husband, wife and family, together with their employee, out of work?

La Sincellerie
49420 Armaille
France

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NAME OF PROPOSER *(in block letters)*

SIGNATURE OF PROPOSER

