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AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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MARKETS AND THE LAW OF UNINTENDED CONSEQUENCES

A talk given by Mr Philip Coggan, Investment Editor of the Financial Times, to members of the Economic Research Council on Tuesday 25th April 2006.

You will all be familiar with the law of unintended consequences. But just to show how unpredictable it can be, I want to give you an example from my real love – cricket.

Unintended consequences for cricketers

In the 1953 Ashes series England won – apparently because of Australian batting weakness against spin bowling on wet wickets. Wet wickets were common during the 1950s and there was a lot of lost play so the English cricket authorities decided to cover the wickets, to allow the spectators more play. That started a long decline in English spin bowling which means that our batsmen now have a weakness against that kind of attack, all because of a move designed to please English spectators.

There are many examples of the law in financial markets. Some, but not all, are due to the actions of governments and regulators. Many just resemble the process of evolution, as random mutations alternatively give advantages to predators or prey, causing the survival rates to change in the other category.

Unintended consequences for pensioners

Let us start with the obvious case at the moment, pensions. The private sector defined benefit pension scheme is dying, killed by kindness and overconfidence. When pensions were promised to the workforce, it seemed like a promise that would cost little in the short term and would offset the demand for other things like higher wages or shorter hours. The ex-head of the British Airways pension scheme told me that when its scheme was set up, in the late 1940s, the life expectancy of staff was 68. It should also be remembered that pensions were very much set up on a discretionary basis; benefit improvements would be made only when they were affordable, and would not be automatic.

But once some people started to receive pensions, a culture of expectations built up. Final salary pensions favoured those employees who stayed with one company throughout their career. They were unfair to early leavers and that was perceived as bad for the economy since it reduced labour mobility. So the rights of early leavers needed to be protected. Then what about those who suffered through the inflationary 1970s? Anyone who retired on a fixed income in the late 1960s saw the real value of their pension savaged over the following decade. That was clearly unfair; inflation protection needed to be built in. Then what about the position of widows, when the breadwinner died early into retirement? Spouses benefits were clearly needed. All these measures substantially increased the cost. Some of these protections were imposed by legislation; some were given away in negotiation.

Lest this sound like a diatribe against socialist meddling, let me point out two further developments. First there was the build-up of substantial surpluses in the 1980s. This was seen by a Conservative government as a possible tax dodge, and limits were imposed on the tax privileges of funds in surplus. Although many people blame the corporate sector for taking pension holidays in the 1990s, this was what the tax system encouraged them to do; no attention being paid to the old biblical story of seven fat years followed by seven thin ones. Secondly, the pension fund was seen by the corporate sector as a cash pot that could easily be raided for redundancy programmes. You have to add to this the many top executives who have been awarded substantial pension packages as a lower profile alternative to higher pay. Pension funds must surely conform to the 80–20 rule; 80 per cent of the benefits go to 20 percent of the members.

These developments plus increased longevity mean that the good intentions involved in a promise that was modest in scope but affordable, have turned into a promise that was widespread in application – but ruinous.

But for many years the cost was obscured because of the substantial returns earned by pension funds. From 1982 to 2000, the equity bull market consistently delivered double digit returns to investors. The traditional actuarial method for assessing pension funds was to discount liabilities by the expected returns on the fund; the greater the proportion of equities the higher the expected rate of return, the higher the discount rate and thus the lower the liabilities. The lower the liabilities, the lower the contributions.

It was not the actuaries' intention to cause a headlong flight into equities but that was the consequence. After all, an actuary who recommended a higher bond allocation would have, effectively, imposed higher costs on the employer.

Westerners were pretty smug about Japan in the 1990s talking about inefficiently allocated capital. The Keiretsu system saw companies investing widely in each other which meant that there was no market in corporate control. But in Britain and the US companies have also invested in each other through their pension funds. Thus when other companies' share prices rose the value of pension funds rose and thus the level of future contributions fell, driving up profits – and share prices. The unintended consequence of a focus on equities was the creation of a gigantic pyramid scheme.

Eventually, of course, this over-concentration on equities was spotted. The famous actuarial paper by Exley, Mehta and Smith was written back in 1997, well before the bull market ended. It argued that pension liabilities were bond-like; a focus on equities was thus inappropriate. It turned companies into mini hedge funds, using borrowed money to speculate in equities and not focusing on their core business of making widgets.

The paper had two further criticisms to make. They pointed out that using expected returns to discount liabilities overvalued equities relative to bonds, and that long term investment in equities involves a risk as well as a risk premium on the returns.

The accountants eventually accepted the Exley arguments; hence the structure of the FRS 17 standard, which discounts pension fund liabilities by the corporate bond yield. And there is a general acceptance of the view that pension funds should move more money into bonds.

The law of unintended consequences is now looming very large indeed. The intellectual shift in favour of bonds coincided with a period when equity markets plunged and bond yields fell sharply, the full burden of past promises suddenly became clear as pension funds moved substantially into deficit, as determined by bond-related measures. The sudden shift caught the industry unawares. Of course, the entire pension fund sector could not have switched into bonds overnight but, with the exception of Boots, very few made significant progress. The problem is that when equity markets are rising, few are tempted to switch into bonds but once a deficit has occurred, the incentive to switching is even lower. Such a move effectively locks in a deficit and commits the sponsor to substantially higher contributions.

But when an industry is, on average, in deficit, that means that some firms' deficits will be very large with insufficient money to fund all the benefits. The pain is most felt by those nearing retirement since, traditionally, existing pensioners have first claim on the assets. I have interviewed a 62 year old with nothing left after 35 years of contributions.

Where there is a problem, governments are tempted to intervene – and the law of unintended consequences strikes again. The government has set up two bodies; the Pension Protection Fund (PPF) and the Pensions Regulator. The former is an insurance-type fund and the latter has power over the industry, designed in part to prevent the PPF from being over-run.

To avoid one classic unintended consequence, moral hazard, the PPF is going to make part of its levy risk-based. This requires an assessment of risk, part of which is likely to be based on asset allocation. Furthermore, the size of the deficit is calculated using a bond yield as a discount rate. So there are clear incentives under the PPF to switch to bonds. Then there is the Pensions Regulator. He has made it clear that companies in deficit should be dealing with their problem within 10 years. This is somewhat shorter than the traditional actuarial horizon. He has also intervened in takeover deals to ensure that pension fund members do not suffer. Both moves have led to substantial one-off payments by companies into their pension funds. Finance directors who have been placed in this situation seem to have said to pension fund trustees, 'I will write you a cheque now – but I don't want to face this problem again'. The fund's answer then, is to de-risk by investing the increased contribution in bonds. And what will the PPF do with its money? It will have a high bond component. And if it takes over a fund because a company is in difficulty, it will seek to switch the fund's equity into bonds.

Now with all this enthusiasm for bonds, it is surely no surprise that we have seen such incredible movements in the bond market. The yield on the 50 year conventional gilt was below 4 per cent for much of the first quarter. Real yield on the 50 year index-linked gilt briefly dropped below 0.4 per cent. Since these yields were used by the Pension Protection Fund for calculating pension fund liabilities, the shifts made the deficits much worse. That created the potential for a vicious spiral in which pension funds chased bonds, driving down yields, forcing them to chase more bonds. Now there is room for a touch of cynicism. The new regime takes money off companies to give to the Pension Protection Fund to invest in government bonds and effectively encourages pension funds to invest more money in government bonds. All this at a time when Gordon Brown is running a substantial budget deficit. Perhaps we are talking about an *intended* consequence in this respect.

I also need to mention some spin-off effects. The aim of the private sector pension provision is to reduce the dependence of the elderly on the taxpayer. But government bonds are simply an IOU secured on future tax revenues. Are not private sector funds that invest in government bonds a very expensive and cumbersome route to elderly income provision? Then there is the question of whether a sudden large injection of cash into pension funds is the most appropriate use of the corporate sector's funds. In a way it is rather like a run on a bank; a liability that was assumed to be very long term has suddenly become short-term in nature. Cash is being diverted from investment into the funding of government expenditure. Money that British Airways would have spent on buying planes has been used to buy bonds. This does not seem to be an economically beneficial equation. And even if companies used their pension fund to buy corporate bonds, rather than government bonds, would the system have been improved? The corporate sector would still have elements of a pyramid scheme. Only in bond rather than equity form. And if the sector issued enough bonds to fund the pension fund industry needs, those bonds would become more equity-like.

Perhaps the biggest unintended consequence of pensions reforms has been this. Final salary pension schemes have been closed to new members and in some cases to existing members. They are increasingly becoming a mark of the public, not private sector. Private sector employees are now in defined contribution, or money purchase schemes. This means that they bear the investment risk; in the past, the company was required to make up any shortfall. In effect, employees had a free put option which has now been taken away. For some that will not matter since, in return, they have eliminated the credit risk that the employer will fail to fund the benefits. So for employees of weak companies, perhaps this part of the trade has been a good one.

However, the other effect of a shift from Defined Benefits to Defined Contributions has been a sharp cut (in many cases, a halving) of the contributions made by employers. This is, in effect, a pay cut and it must, other things being equal, lead to workers receiving lower pensions than they would have done under a Defined Benefits scheme.

So the long march of pensions reform and pensions regulation has meant that for the private sector employees, they have not got a more secure Defined Benefits pension, but a riskier, less generous Defined Contributions pension instead. *And* the financial markets have been distorted, first into equities, then into bonds, along the way. A plethora of unintended consequences, indeed.

Unintended consequences for Managers

As another example from the financial markets, take share options. Option programmes were devised to reward executives and get round the agent principal problem whereby the interests of the shareholders and managers were not aligned. This problem was exposed in the 1980s, when investors felt aggrieved by the insider perks enjoyed by executives and the lack of accountability to shareholders. The theory of options sounded good; executives would only prosper when shareholders did. But options are derivative instruments; the gearing meant that executives would do a lot better than shareholders when things went well. Now those who have studied the 'Black–Scholes' formula will know that the key variable in determining an option's value is the volatility of the underlying asset; the greater the volatility, the more valuable the option. Thus options give executives an incentive to take risks, since if the risk pays off, they will make a fortune.

Options also give executives an incentive to take liberties with their accounts – and give them no incentive to pay dividends since option holders benefit solely from the rise in the share price, not from the investor total return. While there has been much analyst comment about the amount of equity being retired from the stock market via share buy-backs, there has been much less focus on the fact that most of the buy-backs were needed to mop up option issuance.

Attempts to adjust accounting standards to reflect the true cost of options were fiercely resisted in the 1990s with corporate lobbyists recruiting Congress to bully the Financial Accounting Standards Board. Only now are changes coming through. The much-forecast collapse of the US technology industry has yet to occur as a result.

The unintended consequence of the widespread use of options has been the enrichment of a generation of executives and the development of the cult of the CEO. After all, if these guys were rich, they must be brilliant. But too little attention was paid to the role that a generally rising stock market (helped by the fall of inflation and a more stable monetary policy regime) played in pushing up individual company share prices. In effect, managers took part of the shareholder's return in the fat years; they did not give it back in the lean years. Worse still, the hero worship of managers in the bull years led to much resentment from politicians and the public during the bear market, particularly given the collapse of Enron and Worldcom. In turn that led to probably excessive regulation, in the form of the *Sarbanes–Oxley Act* that has driven foreign companies away from the

New York market. Thus, arguably, an unintended consequence of options was excessive regulation.

Unintended consequences for Savers and for Homeowners

Now we can look at the structure of the financial services industry. Governments traditionally have felt that individuals should be encouraged to buy life assurance, and so has offered tax relief on such products. A whole industry was created to sell life products, with brokers specialising in the sector, often using a mortgage application as the contact point.

When tax relief on life assurance was abolished in 1984, these brokers had to find a new raison d'etre. This was immediately granted them by the creation of the term 'independent financial advisor'. But their remuneration was still largely commission-based so they were, in effect, salesmen; they had an underlying interest in selling products that paid commission (such as insurance company funds and unit trusts) and no interest in selling products that did not (such as investment trusts and National Savings).

This meant two things for the savings industry. First, it was dominated by insurers who had the distribution network. Insurance policies tend to be long term in nature, with small initial premiums. These premiums were low relative to the cost of making a sale. The result was that, when clients redeemed policies early, a lot of their premiums were eaten up by those costs. This led to a lot of customer dissatisfaction.

Secondly, there was little incentive for the fund management industry to develop low cost, no load products. Those would have to be sold off the page, direct to investors, cutting out the 'independent financial advisors' that sold the bulk of their funds. Why alienate your core distributors? So the UK was slow to develop index funds, or other low fee products.

Furthermore, when the government tried to introduce lower cost savings products, through the Sandler review, the industry resisted. Stakeholder pensions have not been the success the government hoped, for similar reasons. It is not worthwhile for people to make the effort to sell them. In turn, the sales driven focus of the financial services industry has undoubtedly contributed to the many scandals we have seen in recent years; pensions mis-selling, precipice bonds or split capital investment trusts, to name but three. Those scandals have prompted disillusionment with the financial services industry and have meant that many people have looked elsewhere to build their retirement nest eggs, most notably in residential property.

So, while I admit it is bit of a stretch, one could say that the recent housing boom is the unintended consequence of governmental incentives for consumers to buy life insurance.

Unintended consequences for Investors

Then there are unintended consequences within the market itself. As we know, markets are a complex adaptive system, in which the actions of participants are constantly changing the ground rules. The markets always seem to have a custard pie up their sleeve; just when you think you understand them, you are sure to end up with your face covered with gunk. Take the world of fund management. In the old days, this was a matter of entrusting your savings, or pension funds, to the man in the know, in the City or Wall Street; he through his contacts (inside tips from brokers, mostly) would steer you right.

But how to know whether he was giving you a good deal? The answer was to measure his performance against his peers. Suddenly, therefore, the key driver for fund managers was not to manage money as prudently as possible; it was not to veer too far from the portfolios of his competitors. Better to fail collectively than singly. So if the competitors were moving out of bonds and into equities, there was every incentive to follow suit. This led to herd-like behaviour.

Eventually, however, judging a fund against its competitors was deemed too broad a brush. As managers specialised, they needed to be judged against the market as a whole – the index. And we all know what happened from there. The business risk was no longer losing clients' money; it was underperforming the index. Indeed fund managers could and have been sued by clients for departing too far from the index (having too great a tracking error, in the jargon).

The unintended consequences of this are fairly well known. Stocks in the index were favoured at the expense of those that were not. In the late 1990s, this was particularly significant as it was possible to float a minority interest in a subsidiary, but then have the entire capitalisation of that subsidiary reflected in the index. This made it very difficult for funds that wanted to match the index if they needed a hundred per cent weighting but, say, only 20 per cent was available. The result was a squeeze higher in the share prices of such groups. Investment banks were well aware of this and took advantage by floating many such subsidiaries, particularly in the technology and telecom areas. At times valuations reached levels that were incompatible with efficient market theory; at one stage for example

3Com's stake in Palm (makers of the Palm pilot) was worth more than the entire value of 3Com itself.

The emergence of indexing and closet indexing undoubtedly played its part in inflating the dotcom bubble, but this was an unintended consequence of the desire to monitor the performance of fund managers more accurately.

Since then, the fund management industry has undergone a shift of tone. Closet indexing is generally agreed to be bad; after all it means that investors pay active management fees for passive-type performance. So one answer has been to go for the opposite tack, what is called unconstrained benchmark investing. Fund managers are given the freedom to ignore the index; in other words to have a large tracking error. The problem lies in the fallacy of composition. The index represents the average of all investor's performance. In a world of closet indexing clients tended to get a result that was just below that average (because of costs). But the same costs apply to unconstrained investing, so the average performance of clients will still be the same. Only the dispersion of outcomes will change. Looked at in a different way, the reward of the average client has stayed the same but the risk has increased. This is a deterioration in the trade-off – unless clients can be sure of picking the top performing fund managers, of course. If there was a sure-fire way of doing so, the top performers would have all the money.

The fund management industry has taken us down two further routes. One is the use of hedge funds, whose expertise (and ability to go short) gives them advantages, it is argued. The problem is that many new hedge funds operate in the equity field as long-short or market neutral funds. But the net return of long-short positions must equal the index (minus costs). And yet the hedge funds charge higher fees. Thus the return to the average client must be lower, and this in a world where most people are predicting low nominal returns.

The second route is the use of diversified investments such as private equity, commodities and real estate. This approach has been highly successful in the hands of US endowments such as Harvard and Yale. The problem again is whether these asset classes are liquid enough to absorb the capital that can be thrown at them. Private equity is well known to be prone to feast and famine surges; strong results lead to a wave of new money, which causes fund managers to compete against each other for new investments, forcing prices higher and reducing subsequent returns. In commodities, we are already seeing the industry changing in the face of new investor money. Traditionally, many commodities have traded in backwardation; futures prices have been lower than spot prices. This is not the case with financial futures, where you always have to pay more.

Investors have been able to exploit backwardation by buying the futures contract and rolling it forward until it becomes the spot price. This roll yield has been an important component of commodity returns. It was noticed by Keynes who argued that it was caused by more producers than consumers wanting to hedge their exposure. The roll yield was thus a premium paid to outside investors to get them to provide liquidity to the market.

But modern investors playing the commodities market have been buying the future. This has meant that oil, for example, is no longer in backwardation. Significantly, gold, the commodity most like an investment, usually has futures prices above the spot, a state known as contango. Commodities have still been going up, so investors will be happy. But the disappearance of the roll yield means their attraction (particularly as a diversifying asset) has been diminished, the unintended consequence of their sudden popularity.

How to escape the law of unintended consequences

So what am I trying to say about the law of unintended consequences? It is not that governments should never intervene; I have tried to argue that markets can get into unstable feedback loops all of their own. It is that governments should try to think beyond the first stage of their legislative aims, think about how investors are likely to react to their proposals and the probable consequences that would follow. Is it sensible, for example, to set a funding standard based on government bonds when there are not enough bonds around for the pension fund industry to buy?

And investors need to think about this as well. The markets are rather like a river flowing inexorably towards the sea but taking a circuitous route to do so. Investors are people who may know the principles by which markets operate but lack a map of the terrain so they can predict the river's route. Some may be skilful enough to windsurf all the way; some will drown; some will realise that governments will try to dam the flow occasionally, with resulting floods, so it is best to get out of the water for the safety of higher grounds. But the great mistake investors should not make is to extrapolate from recent events, and assume that the flow will be in a straight line. You have to allow for some bends.

How far forward should they think? There is quite a good test put forward by behavioural economists. They ask a room full of people to pick a number from 1 to 100, with the prize going to the correspondent who guesses two thirds of the average guess. I shan't do the exercise here but just to take you through the reasoning, if the average guess were 50, the winner should say 33. But of course, if everyone in the room thinks through to that stage, then the winning guess should be 22. And so on. If everyone in the room were completely rational, then everyone would guess zero. But guessing zero never wins, because everyone is not rational. The answer seems to be to go through three stages of reasoning and guess 15. We are stuck, it seems, in a world where even our rationality can defeat us. Nevertheless, we have to allow for some feedback effects when imposing regulations or anticipating investor reactions.

In short, to escape the law of unintended consequences, you have to be clever but not too clever by half.

FROM HERE TO MEDIOCRITY? HAS THE UK's ECONOMIC PERFORMANCE IN RECENT YEARS FLATTERED TO DECEIVE?

Extracts from a talk given by David Smith, Economics Editor of The Sunday Times, to members of the Economic Research Council on 8th March 2006

In answer to my title question, I want to tackle two areas of criticism of the current UK economy which readers of The Sunday Times have expressed.

The first area concerns demand. 'Where', they ask, 'would we have been in recent years without the consumer? Hasn't it all been a consumer-driven, debt-driven economy?' And, related to that, 'Hasn't it all been about the public sector? Haven't all the jobs that have been created been public sector jobs? Hasn't it all been either consumer-driven or public sector driven, and hence unsustainable?'

The second area concerns supply. 'What is happening? How much damage has been done to the supply side of the economy?'

The anatomy of national expenditure (GDP) growth

If you look at the UK economy under New Labour, then the average growth rate for the period 1997–2005 is a very respectable 2.8 and there has not been a single quarter of declining GDP during this time. That is good by past standards but we should note that this period of growth started in the spring of 1992. In contrast to most other big economies (which have had at least mild recessions) this is an interesting and very respectable record.

But it is also highly unusual that the New Labour era has been buoyed by a house price boom taking prices to almost three times the level they were in the mid-1990s. We have seen a big increase in household debt and, very unusually, in every year under Labour, including (just about) 2005, consumer spending has grown faster than GDP, faster than the economy as a whole and, as far as we know, that has never happened before. The average growth of consumer spending over the period 1997–2005 has been 3.5%.

In the past, something would have happened to interrupt this – in terms of stop/go, or a sterling crisis perhaps. But now, given that this cannot continue and probably is not continuing now, I think we are moving into a period of slower consumer spending growth.

Now if, during 1997–2005, consumer spending had only grown at 2.8% (in line with the rest of the economy) rather than at 3.5%, GDP growth would have been about 0.6% lower so we can say that without continuous high levels of consumer expenditure GDP growth would have been something like 2.3%. Maybe that is a reflection of the fact that we have been so reliant on the consumer.

What about public spending? What has been the record on public spending 1997–2005? Has it grown every year much faster than GDP as a whole? Well in fact that has not been the case. If we look at the entire period of New Labour, public current spending has grown by an average of 2.7% a year, slightly below the rate of growth of GDP. However, this is an average which includes the first two years of restrained expenditure. Since 2000, public spending has grown by about 3.4% a year, very similar to the growth in consumer spending.

Public spending has a much smaller share in GDP than consumer spending so we cannot take as much away from the GDP growth to account for this more rapid growth in public spending on the economy as a whole. But it is still legitimate to take a little bit away from that, so we can take 0.1/0.2% a year away.

What we are left with is that, in the absence of much more rapid growth in consumer spending than is normal, much more rapid growth in consumer spending and public spending than is sustainable – we are left with GDP growth of just over 2%, perhaps 2.2% over this period, rather than 2.8%.

What these figures show us is that it has not quite been the miracle performance that the bald figures from the national statistics tell us, but there *have* been unusual unsustainable things happening over the past few years which *flatter* economic growth from the demand side. In the absence of this very rapid growth in consumer spending, this (I think) one-off adjustment for lower interest rates that we have seen, in the absence of this extremely fast increase in public spending from a low point, economic growth in the UK would have looked rather ordinary. It would still have been a little better than the average for the EU, but it would not have been particularly impressive.

Such an 'ordinary' growth rate would have been inconsistent with falling unemployment over that period. We have seen an increase of about 700,000 in public sector jobs from 1998 to 2005. It has not been the case that the whole of the labour market has been driven by public sector employment, but it has been a very important contribution. If you think about the number of jobs that have been created by the excessive growth in consumer spending, again you are left with the impression that it would not have quite like this.

Although we all got used to the idea that the UK is a very strongly growing economy, maybe the trend growth rate is about 2.75% – as the Treasury assumes. Maybe the real picture is more modest than that at just over 2% a year, and maybe that is the picture going forward from here. I think the idea that I would emphasise in particular on the consumer side is that we have somehow had a feast for consumers and we are now moving, not necessarily into a famine period, but a period of much more subdued growth.

Productivity, Investment, Exports – the supply side

According to the OECD, UK income per head ranks 14 out of 30, on productivity we rank 15, on the proportion of the workforce having high as opposed to low skills we rank 17, on R&D spending we rank 14 and on infrastructure 17. So on all those things the verdict is 'could do better'. In fact, between 1997 and 2006, on all these measures there has been very little progress.

Then there is the ongoing rise in the tax burden. And we know about the scandalous waste when it comes to public spending and the fact that, however hard the Office of National Statistics works on the figures, public sector productivity is poor and probably declining.

Although the global economy is strong, business investment in the UK has been weak and is now at a record low – which must affect growth long term. There are all sorts of reasons for this. One of them is pensions and the government's own goal on that, but there are plenty of other reasons why business feels that the economy, which was a deregulated economy in 1997, is an over-regulated economy now. The UK is still a place where foreign investors come to buy cheap British assets – it looks likely that Britain will have attracted more direct foreign investment than any other country in the world last year; it is not necessarily a place where British businesses want to invest, and that is a real concern in terms of the outlook going forward.

Britain's exports and imports were fairly balanced in 1997 but there is now a chronic deficit – we had a record £56bn deficit last year. Nobody worries about the trade deficit any more, but the position is a deteriorating one and, in the long term, a worrying one.

So why aren't we doing worse than we are? I think the answer to that is that there is always a long time lag. With these things there is definitely a tipping point but it takes time to reach that. I firmly believe that it took 10 to 15 years before the full effects of the Thatcher reforms of the labour market came through in a beneficial way, and it may be the case that it takes 10 or 15 years before some of this supply side damage comes through in a big way. The encouraging thing is that it will probably happen right in the middle of Gordon Brown's premiership.

Quentions and answers

Q. Over the last few years, the 'terms of trade' have moved massively in our favour. How important has that been?

A. Very important and the beneficiaries are pretty much the consumer. It has held back inflation and the Bank of England has been able to respond to successive difficulties by cutting interest rates.

Q. Is continued membership of the EU advantageous or damaging?

A. The origins of the majority of cases in the re-regulation of the UK economy are EU directives, but this government has been a particularly willing participant in this process, for example on the EU Social Chapter. On the broader argument of open markets in Europe, one has to say that the main beneficiaries of the single market are German exporters to the UK. My belief is that any freedom is better than no freedom so it is better that we have a single market than not, but it doesn't work particularly to the UK's advantage at the moment. I think the balance sheet on membership is pretty finely balanced. I don't think there is a huge advantage that we are in there but I wouldn't be arguing for withdrawal at the moment.

Q. 1972 – inflation – PSBR. At that time a group called the Economic Radicals published something called 'Memorial to the Prime Minister' in which they forecast that the vast increase in the public sector borrowing requirement would lead to higher rates of inflation – and it did. Why are we not similarly worried now?

A. Yes, in 1972 economists such as Alan Walters, David Laidler and Walter Eltis were rightly concerned at the growth of the public sector deficit. The slightly shocking thing when you look at public finances now is that the steady state position – that meets the 'golden rule' – is to have about £30bn a year of public borrowing. This is large but not as large in real terms as the borrowing requirements in the early 1990s or the early 1970s. I think a major difference is that international capital markets are much more open and mobile now so governments don't get into the problems that they did in the 1970s.

Q. Is there anything that a British government could usefully do to boost productivity?

A. You have to be a bit sceptical about what governments can do. Improving education, skills and infrastructure may do a little bit of good at the margin but the big thing is investment. Though it may be partly due to French labour laws, the fact is that the average French worker has something like 80% more capital equipment than the average British worker. We need to invest more.

MARKET NERVES

Damon de Laszlo

While April was quiet, May has turned into a market bloodbath, and June has seen little improvement. The complacency of the markets as we came out of April was rudely shaken for no reason that has not been apparent for some considerable time. Governments around the world, along with the Central Banks, have been tightening money supplies and raising interest rates. The economic growth in Asia has been driving up all commodity prices but the downward pressure on consumer prices indexes through Chinese industrialisation has kept inflation figures low. This last trend is beginning to change as the Chinese Government reduces the export incentives of its industrial base, and allows its currency to creep up against the dollar, increases the domestic prices of commodities, particularly oil, and is increasing its industrial rates of pay. This inevitably will lead to a rise in prices in the West. Again all fairly predictable. While we seem to be at the low water mark for inflation, the tide is coming in and the pressure on prices that will feed through into the indexes is growing steadily.

While all the above is not new, perhaps the sub-conscious realisation that Western Governments are losing their credibility is really what is spooking the market. The Russian government seems to have a clear strategy of using its huge energy reserves as a political weapon against the West. The West continues to build gas-fired power stations as its primary new source of energy and replacement source for ageing nuclear and coal fired stations, further increasing dependency on Russian supplies. Another new development in the Russian economic power game is an effort to dominate Europe's steel industry, an industry dependent on energy.

China pursues a global strategy of buying and financing commodity resources around the world, gathering up assets in Latin America and Africa, it is also becoming the major customer for Australian raw materials and New Zealand agriculture.

These policies are entirely logical, bearing in mind that China now represents some 15% of world GDP on PPP basis, larger than the Euro zone, and is growing at around 10% per annum. These figures are inevitably having an enormous impact on world raw material resources and will continue to do so for some time to come. It is worth remembering that China represented less than 5% of World GDP, again on a PPP basis, just twenty years ago.

The two elephants in the room of world economics, Russia and China, are largely ignored in the debates of the European and US politicians. Europe bickers incessantly and is almost wholly distracted by domestic politics and interstate political rivalries, while the government of the USA, distracted by Iraq and Iran, is failing to grapple with the problems of Latin America and other geo-political issues. The failure of Western Governments to produce any strategy to deal with the looming energy shortfall is extraordinary. The USA's dependence on imported energy has been growing for over forty years; today some 40% of oil and gas has to be imported. Europe's energy supply situation has been deteriorating rapidly over the last ten years and this deterioration will increase even faster as North Sea production declines.

The rapidly rising prices of commodities are the natural consequence of some twenty years of surplus, which resulted in low prices discouraging exploration. The rapid growth of China and India has absorbed these surpluses and industry and economics will work to correct the situation as higher prices slow down demand and encourage exploration. The economics can only work, however, if government does not intervene. In the case of energy markets, there is heavy government intervention and regulation. It has been fascinating to watch the last ten years of UK Government's energy policy go from an opinion that the solution can be found in windmills, through the confusion of Kyoto, to the shock of realisation of Europe's dependence on Russian gas, to the announcement by the Prime Minister that nuclear energy needs revisiting – having previously decreed that nuclear power should be phased out and that the country should sell off its nuclear technology.

Having said all that, for the near future world industry continues to produce huge productivity improvements that are leading to increased business profitability and prosperity in the West and Asia. Markets are never rational and pessimism is not a profitable strategy.

A NEW ERA FOR MERGERS AND ACQUISITIONS

Robert McGarvey

Mergers and Acquisitions, are they about to get more complicated?

Sir David Tweedie, Chair of the International Accounting Standards Board ('IASB'), is preparing to throw a regulatory 'spanner' into the international mergers and acquisition ('M&A') works. He and his team, toiling away quietly in their Cannon Street ivory tower are developing new, more rigorous international accounting standards. These new standards, particularly those linked to the recently issued International Financial Reporting Standards '3' ('IFRS 3[1]'), will impact the M&A game significantly by, amongst other things, formalising the reporting requirements of 'intangible' assets in business combinations. To quote Bernard Kellerman writing in CFO magazine[2]: *'the effect of international financial reporting standards (IFRS 3) on business combinations – essentially the acquisition of control of one business by another – is fundamentally changing the way intangible assets are recognized, measured and treated …'*

What does this have to do with hard-headed M&A activity? Well, everything. Corporate earnings and ultimately all significant corporate value are rooted in 'assets' of one kind or another. According to accounting theory, assets are those resources a company owns (tangible or otherwise) that can be linked to earnings; indeed assets are the very source of corporate earnings, and as a consequence heavily influence corporate share prices, market capitalisation etc. So what's the problem? Well according to Simon Delgarno, associate director at Leadenhall Australia, *'Intangible assets which would previously never have been capitalized now have to be … this means that Chief Financial Officers (CFOs, and everyone else involved in M&A) are going to have to manage an entirely new class of assets ….'*

As a rule the M&A process is about the accurate identification/valuation of assets and liabilities, and then (once negotiations and paperwork are

1 The International Accounting Standards Board, IFRS 3 *Business Combinations* was issued in March 2004 and is applicable for business combinations for which the agreement date is on or after 31 March 2004. It is presently in a review process; see June 2005 Exposure Draft and IAS 38 for more details.

2 Hidden value increases New Accounting standards create risks and opportunities in management of intangible assets, Bernard Kellerman, CFO, 01 May, 2005

completed) transferring or amalgamating those assets (earnings centres) within the new, acquiring or merged company.

The rise of intangible assets is complicating this identification-valuation-amalgamation process considerably. Today acquiring companies and their teams of lawyers, accountants and investment banking partners are faced with an uncomfortable reality, upwards of 70% of the value in modern corporations lies outside the comfortable confines of traditional tangible 'hard' assets[3].

This is quite a change from the recent past. A study conducted by the Stern School of Business at New York University (NYU)[4], comparing the market to book value of 3,500 US companies over a period of two decades shows a dramatic decline in the relative importance of traditional 'tangible' assets (with a corresponding upward rise in intangible asset value). To quote Ben McClure: '*In 1978, market value and book value were pretty much matched: book value was 95% of market value. Twenty years on, book value was just 28% of market value.*'

What are the implications of all this for M&A professionals? Well the rise in value and importance of intangible assets means that the experience, skills and norms that were, until recently, applied to the M&A process need to be supplemented by a suite of new skills, advanced know-how and unfamiliar risk factors associated with intangible assets. It all sounds like more work and a slower deal flow: something deal makers and their investment banking partners are not going to like.

Intangible Assets: International Accounting Standards (IAS 38)

The IASB with the US based Financial Accounting Standards Board ('FASB') are formalising accounting standards for intangible assets, building on FASB statement 141. International Accounting Standards document No. 38 ('IAS 38'), the IASB Statement on intangible assets, recognises a variety of intangible assets including many of the familiar forms of intellectual property, patents, copyrighted materials, trade marks, etc. plus a variety of conventional contracted services including marketing rights, franchises,

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3 *The Knowledge Economy*, Britain & Overseas Winter 2004, Robert McGarvey: in this article B&O readers may recall, the author discussed the nature of the knowledge revolution while examining the reasons why Economics as a science lacks the perspective to deal effectively with this new class of 'knowledge' assets.

4 Ben McClure, '*The Hidden Value of Intangibles*' January 6, 2003.

licenses etc. But IAS 38 also identifies a number of unfamiliar customer-equity based assets including customer lists and a variety of critical customer and supplier relationships.[5] IAS 38 mandates an enterprise to recognise an intangible asset if three critical criteria are met:[6] (1) the asset must be identifiable, i.e. the intangible asset is separable and has associated legal, contractual rights; (2) control, the controlling entity must demonstrate it has the power to obtain benefits from the asset; and (3) future economic benefits, the assets must have either associated present or future revenues or demonstrably reduce future costs.

The Impact of Intangibles on M&A

It is clear that the full impact of the knowledge asset revolution is only now beginning to make its presence felt in board rooms and in M&A deals. Consider the AOL–Time Warner merger of just a few years ago. America On-Line (AOL), an internet service provider, merged in 2000 with media giant Time-Warner. At the time of the merger, (January 2001) AOL had a market capitalisation of US$164 billion, while the much older and more established Time-Warner had a market capitalisation of just over half that value, US$83 billion (which essentially made the deal an AOL acquisition). Much of AOL's market capitalisation at the time was comprised of intangible assets, principally its high profile brand asset. AOL's brand asset value rested upon the assumption that customers would continue to find AOL attractive as an internet service provider, and as a result advertising customers would continue to pay premium prices to advertise with AOL (the two principal sources of AOL's earnings). Unfortunately for shareholders, no one at AOL–Time Warner nor any of their highly paid investment banking advisors had sufficient skill or experience with intangibles to deal with such an unusual situation. As a result AOL's brand asset was never clearly or separately identified and therefore valued properly; consequently

5 A notable exception to this liberal interpretation of intangible assets is an 'experienced workforce' an important internally generated form of human capital, which remains out of bounds as far as accounting standards go, at least for the moment. So although organizational know-how is not yet considered an accounting grade 'asset' it nevertheless remains a critical form of capital for most organizations. It might be appropriate for management to begin treating this know-how 'like' an asset (albeit informal) in anticipation of further developments in accounting standards.

6 [IAS 38.8]

no attempt was made to consider what internal or external conditions might impair the AOL brand going forward[7]. The events that followed – the collapse of AOL–Time Warner in the immediate aftermath of the merger – were, needless to say, disastrous for shareholders.

It is in response to events such as this that the IASB began developing new more vigorous standards in respect to intangible assets. Dealing with the new requirements will not be easy or simple, but given the growing importance of these assets and the need to protect shareholders and other investors, the accounting profession had to act, the integrity of the financial reporting system itself was at stake.

The new standards will create many difficulties for operating professionals in the M&A field, and will no doubt be resisted at many levels, but… one has to ask, could there be an upside to all this? It is quite possible that intangible assets may hold the key that unlocks one of the great mysteries in M&A activity. Many observers (and not a few shareholders) have been shocked by an imponderable yet observable reality that even as M&A activity has become more sophisticated over the decades with far greater access to data, employing ever more powerful analytical tools, success in mergers and acquisitions continues to be a hit and miss affair, to say the least.[8] Perhaps a greater, more fulsome knowledge of the defined assets (both tangible and intangible) being exchanged, and appropriate management of those assets both before and after the 'deal', may go some way to resolving the question of why M&A success has been so difficult to come by in recent decades.

M&A 'Synergies'

There are various drivers and motivating factors at play in the M&A world. Apart from personal glory (or greed), M&A deals are often driven by many justifiable market-consolidation, expansion or corporate diversification motives. And, of course, ever present as an inspirational force in M&A is the old reliable financial, generally tax related motivation. But whether the deal is a horizontal merger designed to eliminate an unwanted competitor,

7 Fools Rush In, Steve Case, Jerry Levin, and the Unmaking of AOL Time Warner, Nina Munk, HarperCollins New York, NY. p 179

8 *Where Mergers Go Wrong,* Scott A. Christofferson, Robert S. McNish, and Diane L. Sias, The McKinsey Quarterly, 2004, Number 2. Research suggests that only 17% of all mergers added value to the combined company, while as many as 53% actually destroyed shareholder value.

a vertical merger to integrate the supply chain or indeed any other related motivation, deal makers can be depended upon ultimately to justify the deal based on anticipated 'synergies' of one kind or another. The landscape of M&A is littered with promises of operating synergies (saving from eliminating duplication in a variety of operational functions) or financial synergies (the larger combined entities may, for instance, reasonably expect to reduce their cost of capital). According to M&A specialists at McKinsey's, '*These synergies can come from economies of scale and scope, best practice, the sharing of capabilities and opportunities, and, often, the stimulating effect of the combination on the individual companies."*[9]

Unfortunately many of these expected 'synergies' simply do not materialise to the extent anticipated after the 'deal'. Richard Thaler, Professor of Behavioural Science at the University of Chicago has termed this phenomena the 'Winner's Curse', while McKinsey's adds: *'Our exploration of postmerger integration efforts points to the main source of the winner's curse: the fact that the average acquirer materially overestimates the synergies a merger will yield.'*[10]

Soft Issues Left Un-addressed

This would seem to beg the obvious question: why do deal makers focus so intently on synergies to justify a merger? To begin answering that question you would probably start by investigating management decision making and the rationale behind that thinking. You would probably not be surprised to find that M&A activity, like most management decision-making these days is driven by the 'numbers'; those apparently hard, quantifiable identifiers that are so easy to read and sit so elegantly on a spreadsheet. The 'numbers' generated by management and their accounting professionals systematise business, with all its vast human complexity, into quantifiable categories, revenues, expenses, gross profits, EBITA[11] etc. all of which helps simplify the hugely complex. When we understand this clearly, the answer to our question is obvious. Despite all the vigorous analysis that goes on in a M&A deal, 'synergies' and all that they imply are the only quantifiable

9 *Where Mergers Go Wrong,* Scott A. Christofferson, Robert S. McNish, and Diane L. Sias, The McKinsey Quarterly, 2004, Number 2

10 IBID *Where Mergers Go Wrong*, For further details on this subject see Richard H. Thaler, *The Winner's Curse: Paradoxes and Anomalies in Economic Life*, published by Princeton University Press, 1992.

11 EBITA is an accounting term = (Earnings Before Income Tax and Amortization)

factors that visibly appear in the financial models.

The problem with the 'numbers' is they don't tell the whole story. There are many 'soft' issues that are critical to merger success, that because they don't appear on the balance sheet, financial statements (or any of the many equations generated in M&A deals) tend to get lost in the shuffle. According to Ron Elsdon, director of retention services at DBM, a human resource consultancy in New York, *'Mergers have an unusually high failure rate, and it's always because of people issues.'* In a similar vein, John Kelly, head of accounting firm KPMG's Mergers and Acquisitions (M&A) Integration division, suggests that many firms focus too much on the *'hard mechanics' of the merger to extract value from an acquisition. Instead managers should concentrate more on 'soft' issues like selecting the right management team and resolving cultural misunderstandings*[12].

Has the Medium Determined the Message?

Could there be a link between what the IASB is attempting to do with accounting standards and the 'soft' issues that seem to play such a critical role in the success or otherwise of M&A? The answer, of course, is yes. The 'soft' issues identified by so many practitioners in the merger integration field are precisely the areas of intangible asset potential that IFRS 3 (and its successors) is insisting need greater attention and more precise definition. Unfortunately there is a big problem, modern management practices, rooted in traditional accounting customs, continue (despite guidance from FASB and other national accounting standards bodies) to underestimate or ignore this 'intangible' asset potential[13]. Amongst the many 'invisible' assets to most organisations today are almost all internally generated forms of human capital, organisational know-how of employees, customer equity in the form of brand assets, as well as R&D and the more formalised intellectual assets,

12 'Most international mergers fail' *http://news.bbc.co.uk/1/low/business/542163.stm*

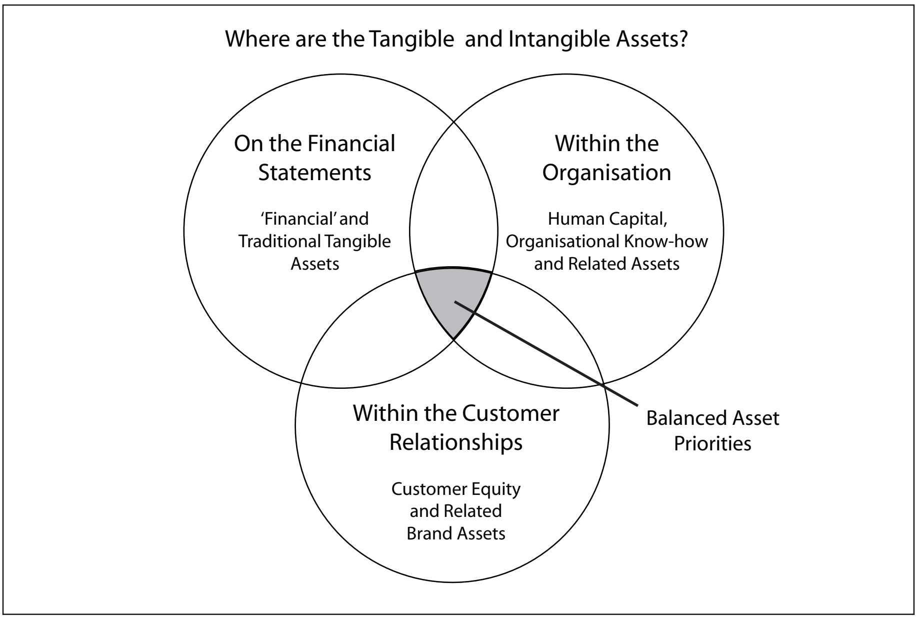
13 As bad as this situation is for business in general, it is even worse in the case of official government statistics. See *Business Weeks*, online article: *Why the Economy is A Lot Stronger Than You Think*, Feb 13, 2006 According to *Business Week* calculations indicate that businesses in the US are investing about $1 trillion a year more in asset building enterprises than the official numbers (which only measure traditional hard assets) show. And if intangible assets were factored into conventional data the US domestic savings rate, far from being negative, is actually positive. The US trade deficit with the rest of the world becomes much smaller than advertised, and US gross domestic product may be growing faster than the latest gloomy numbers suggest.

including copyrighted software, patents, trademarks etc. All are generally excluded from the balance sheet and/or treated like expense items on the financial statements. It's little wonder that 'soft' issues are a problem in M&A, they do not appear on the management radar screen. In this sense the paradigm – the accounting based 'financial' theory of management – has itself become a serious detriment to meeting the requirements of IFRS 3 and ultimately improving the success of M&As.

Managing to a Balanced Asset Strategy

Companies involved in M&A have long histories of scrambling to meet synergy targets by hastily laying off head-office personnel and other staff as part of their restructuring plan; as a result many lose not only experienced staff but customers as well. So widespread is this 'scramble for synergies' in M&A that it breeds a kind of complacency and cynicism in precisely the areas of the business where trust is most needed in a period of transformation

Consider a classic example in the customer industry, the Hewlett Packard (HP)-Compaq merger. This merger got off to a bad start in 2001 as a result of mismanagement of the organisation's human capital. One thing can be



said for mergers in the high tech field – employees will read the prospectus and do their own research. And while HP and Compaq staff heard management proclaim publicly that ‘our people are our greatest strength’ they could also do the hard maths. They all knew that the combined HP-Compaq would have to rid itself of approximately 15,000 employees in order to achieve the expected ‘synergies’[14]. Needless to say morale in the high tech firm collapsed post-merger. As for the HP and Compaq customers, they voted with their feet. HP had always been known for its technical competency, and particularly for the reliability of its technical ‘road maps’ which played a key role building customer confidence and loyalty. After the merger the company struggled to find its direction, the ‘road maps’ lost credibility and it was no surprise to insiders when, on the first anniversary of the merger, arch-competitor Dell surged to number one in the industry, surpassing HP-Compaq in key areas. As a result it is only now, five years and a new CEO later that the HP share price has recovered to its pre-merger values. Much of this damage might have been avoided if HP management had balanced its asset priorities, focusing their merger strategy on growth opportunities rooted in best use of the combined assets, as opposed to forging ahead with damaging and largely unachievable cost ‘synergies’.

Programming for Success

The knowledge asset revolution today is simply overwhelming older standards, norms and systems. The accounting based ‘financial’ theory of management was ideally suited to an ‘industrial’ economy, where assets were predictable and predominately tangible. Despite a long history and sound pedigree, these traditional management tools have several structural limitations in an evolving knowledge economy. Because of how it formulates and presents financial data, the traditional accounting based system ignores the new classes of assets and focuses management’s attention too intensely on cash flow, tax considerations and (shorter term) return on investment (ROI) priorities, as opposed to the longer term best use of, and return on, corporate assets (ROA).

The reasons for building competencies in identifying, valuing and man-

14 For more details see, HP/Compaq joint proxy statement/prospectus filed with the SEC on November 15, 2000. For a description of the interests of executive officers and directors in HP see the proxy statement for HP’s 2001 Annual Meeting of Stockholders, this was filed with the SEC on January 25, 2001.

aging intangible assets speak for themselves, but certainly the new IASB reporting requirements[15] will set a new, higher, standard of competency. Many M&A specialists will – no doubt – continue closing their eyes to intangible assets, lumbering them indiscriminately into goodwill (no doubt justifying it all with tax benefits). Increasingly, however, investors will demand that management at least be able to answer simple straightforward questions such as: '*Exactly what assets are we buying? And has the analysis demonstrated that we're paying an appropriate price for these assets?*' Furthermore, in this increasing litigious environment[16], investment bankers are going to find it increasingly difficult to sign off on an M&A deal that lacks a comprehensive asset inventory.

Despite the difficulties in meeting these new requirements, there is a potential upside. The benefits of proper identification of intangibles can have significant financial impact. Knowing, for example, the differences between customers and customer 'equity' or the subtle distinctions between cost centres associated with preliminary 'research' which must be expensed in the year they were incurred or cost centres associated with legitimate asset building 'development' activities, which can be amortized over the useful life of an intangible asset, can obviously have a material impact on the size of your balance sheet, operating profits, EBIT and net earnings per share.

The new accounting standards will challenge management, investment bankers and other M&A specialists to achieve a greater balance in their priorities, and to identify the broad asset potential of companies. This broader perspective should improve management decision making, provide a keener insight into the ultimate sources of market value and perhaps increase the likelihood of success in M&A activity – something that mutual funds, pension fund investment managers and other shareholders will no doubt welcome with open arms.

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15 According to the *IASB Work Plan – projected timetable as at 31 March 2006*, IFRS 3 the Statement on business combinations is scheduled for finalisation and publication in the second half of 2007, the effective date for implementation is normally 12–18 months later.

16 See Ronald Perelman vs. Morgan Stanley, Mr Perelman stunned the investment world when he successfully sued Morgan Stanley for offering advice in bad faith during the Sunbean-Coleman merger. Although at the time of writing the case is still in dispute Morgan Stanley will likely have to pay Mr Perelman hundreds of millions of dollars in compensation over its advisory role in this merger.

FULL AHEAD TOGETHER

*By Ian Baird**

This is a biography of a long standing member of the Economic Research Council who attended meetings in the 1980s and who is now aged 86. It is not the story of a famous man or one who has contributed greatly to theories of economics, but it is the story of an interesting 'mover and shaker', an example of that entrepreneurial clay without which there would be little point in practising our subject.

Chugging through chapter after chapter, a picture of George Scales begins to emerge on three levels – a life history, a personal psychology and a philosophy, and each has something to offer the reflective reader.

As a life history this is an account of a lad who was something of a failure at school but who turned into the ultimate 'late developer', the tortoise who outran the hare. Successful wartime service was followed by success in business and then, in later life success in intellectual curiosity and accomplishment - including many published letters, talks and industrial innovations. Much of his life has been spent on his farms and I have known other farmers like him - dependable and practical and with a shrewd eye for a deal. Forever looking to buy a bit more land, aiming to cut costs even by resorting to monoculture and arriving, in the course of time, at a position of not inconsiderable wealth. But if that is the skeleton of this story the flesh is numerous incidents to bring a smile (or a grimace) to anyone who can relate to the trivia, trials and tribulations of life's experiences set in the English countryside. The book is a valuable archive of material for the scriptwriters of The Archers.

At the level of personal psychology, the book is a full introductory statement for any analyst to start work on. Placing Scales on the couch, he would soon be defined as a dominant extrovert, impossible to compete with in his own domain, and a man clothed in such an impregnably acceptable persona that those close to him must have yearned for some chink of vulnerability. Freud would have understood Pat's (Scales' late wife) dilemma as reluctant 'contained' to Scales the 'container'. Jung could go much further.

Jung famously proposed in his 'functions of the mind', four areas of mental activity which he labelled thinking, intuition, feeling and sensation. We can consider these four as a diagram with the areas at 12.00, 3.00,

* Available from Scales Farms Ltd, Cobbler's Pieces, Abbess Roding, Ongar, Essex CM5 OJJ. Tel: 0279 731255.

6.00 and 9.00 o'clock. ‘Thinking’ refers to logic, calculation and deduction, ‘intuition’ refers to the ability to draw ideas as if from nowhere, to ‘see’ beyond and to inspire, ‘feeling’ involves the ability to judge, to understand feelings - to get on with and perhaps to manipulate, others, and ‘sensation’ refers to the six senses involving the ability to be practical, down to earth and inventive. Recent studies have suggested that traditional ‘IQ’ testing concentrates only on ‘thinking’ and there should be a concept of ‘emotional intelligence’ concerned with ‘feeling’, a concept of ‘spiritual intelligence’ concerned with ‘intuition’ and a concept of ‘creative intelligence’ concerned with ‘sensation’. Jung argued that most of us are strong (‘put our best foot forward’) in one function, moderately good in the two adjacent functions and weak in the opposite function as displayed on the clock diagram. Only a fortunate very few of us can hope to be confidently functioning on all four functions. Almost all of us operate mostly on our strongest function and, by projection, despise and belittle (thus narrowing ourselves in the process) others who happen to be strong in the opposite function – our weakest.

Scales quite clearly excelled in 'sensation’ in his early life, and to this day lives on the banal inspiration of ‘proving his school teachers wrong’ whilst he dismisses the divine, rejects religion and generally shows a Jungian ‘weakness’ regarding ‘intuition’. It is sad, but you just cannot reach a cynic. In the Navy and in his business life Scales developed an impressive and mature feeling function, and then, later still, an ability with ‘thinking’ that would be the envy of any ‘A’ level Maths candidate.

As an exploration in philosophy, interesting thoughts come tumbling out, especially towards the end of the book. Scales the sage, unread in the great literature of political thought, has travelled quite a way down the path of interpreting the world through analogy with his understanding of nature and farming. But he clearly misunderstands the modern city, the open society, and culture as a source of values. But his is a splendid and utterly credible display of what political theorists refer to as organic or naturalistic, as opposed to mechanistic political thought. He is Freud's sun worshipper and David Attenborough’s student of evolution. His ideas lie in the tradition of Plato, Machiavelli, Hobbs and Marx – but definitely not in the tradition of Christ, Lock, Mill and most especially Hayek.

Food for thought. A book that is tedious in some places but interesting in others. Not a book to win prizes or fame but a book in a category all of its own.

J. B.

LETTER

A Response from Mr Brian Lewis to 'UK Housing Economics in the 21st Century' by Ms Kate Barker (Britain and Overseas, Spring 2006)

Although Economics is referred to as the 'dismal science', I am often surprised at the veneration society pays to economists for the practical work they do. At first sight, the world is full of economic problems, which are still very poorly understood by academics and politicians.

Your recent article on housing in the UK by Kate Barker was strangely unclear as to what was really wrong. Demographics and the change in the size of housing units now required by people, who now tend to live alone, might be one answer. We hint at slow or negligible growth in birth rates, presumably reducing the need for new housing, while at the same time insist we need new housing. I still remember my grandmother, who lived in a four bedroom house!

I always liked the economic idea that even where we knock down and destroy valuable buildings, this nevertheless counts as an increase in wealth measured as economic activity. It suggests if we knocked down everything, we would nevertheless be richer on paper.

In my own ecology lectures, I now start with the fundamental fact that when I was born in 1934 the world population was 2 billion. Today 70 years later it is 6.5 billion. In 30 years time it will be 11 billion. This is an extraordinary rise in population, which must impact on everything we do – whether that is on legal and illegal immigration into the UK, on size of households, or on land available.

I am not an economist, and must therefore be accounted an ignoramus on such abstruse matters, but having spent my life in Marketing, I have begun to wonder what is it that economists know that marketing experts do not. The relationship between supply/demand and prices seems to me to be such a fundamental one, yet the powers-that-be and economists seem to spend much of their time trying to repeal the laws of supply and demand. I therefore suspect that an old marketer like myself exposed to continual movement of markets on a day-to-day basis sometimes understands what is happening in the world rather better than abstract thinkers in economics.

Brian Lewis
15 Calcutta Street, Merville Subdivision, Paranaque MM, Philippines

APPLICATION FORM

To the Honorary Secretary
Economic Research Council
7 St James's Square
LONDON SW1Y 4JU

Date......................................

APPLICATION FOR MEMBERSHIP

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

This application is for
(delete those non-applicable)

Individual membership (£35 per year)
Associate membership (£20 per year)
Student membership (£15 per year)

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PROFESSION OR BUSINESS ....

REMITTANCE HEREWITH...

SIGNATURE OF APPLICANT ....

NAME OF PROPOSER (*in block letters*)..

SIGNATURE OF PROPOSER..