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AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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The Bank that Forgot Money ........ 3
Housing Policy for the 21st Century ........ 16
Business and Investment for 2007 ........ 21
Energy Security the Greatest Worry – Not Climate Change ........ 23
Lions, Donkeys and Dinosaurs ........ 24
Disappearing Britain ........ 26
The Hare and the Tortoise ........ 32

BRIAN READING – NICHOLAS BOLES – PETER DAVISON

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# THE BANK THAT FORGOT MONEY

*By Brian Reading*

We moved to New Zealand in 1999. I now telecommute from Pukekohe. Twice a year I visit London and catch up with old friends. These include fellow members at the Economic Research Council, a few of whose meetings I am able to attend. Last winter (summer your time) Jim Bourlet asked me to contribute to Britain and Overseas. How long? “Only 5,000 words” he replied. To an 800 word sprinter like me, that’s a marathon. I don’t know whether I can make the distance but here goes.

## From Money Growth to Output Gaps in Forecasting Inflation

With the ERC’s 75th anniversary coming up next year, it is just four years older than I am (a baby slumper). When I began learning economics over half a century ago, money seemed no longer to matter. MV = PT was merely of academic interest. In Britain credit was regulated and rationed – HP controls, ceilings on the growth of bank advances, changeable reserve (largely Treasury bills) ratios and discount houses that always covered the tender bill issue. Credit was held artificially cheap (which helped the government to service a national debt three times nominal GDP) and artificially scarce. The majority of bank assets were public sector debts. Demand management was Keynesian budgetary policy plus changes in credit regulation – not that Keynes himself ignored money, far from it. That was during the ‘great prosperity’ of the 1950s and 1960s. But reforms, notably the unfortunately timed Edward Heath’s relaxation of ‘competition and credit controls’ and the ‘great inflation’ of the 1970s and 1980s brought (deregulated) money and credit growth back to centre stage – Milton Friedman became the great guru, Enoch Powell and Sir Keith Joseph his British disciples. There were explicit money growth targets. But following the premature ‘death of inflation’ money went out of fashion again, at least amongst central bankers – most importantly the Greenspan Fed. Paradoxically monetary policy simultaneously assumed increased importance.

It is dangerous to generalise about central banks. They differ from each other and over time. Today the Fed seems to pay little if any attention to money and credit. It can be said to be ‘reactive’ to the latest inflation and growth indicators – but that is not entirely true. The Bank of England’s Monetary Policy Committee is ‘proactive’ explicitly basing policy

on forecasts – but these change in the light of the latest inflation and growth indicators. The Bank's inflation forecasts at least give a passing nod to money and credit. The ECB until recently could be called 'inactive'. It more simply observed an inflation ceiling regardless of the consequences for growth. But it paid somewhat more attention to money growth than others.

Inflation is no longer forecast from money and credit growth. The projected 'output gap' has taken their place. This is the difference between the forecast level of real GDP and its potential level. The potential GDP level is a concept akin to NAIRU, the non-accelerating inflation rate of unemployment. The potential GDP level is defined as that at which inflation is neither accelerating nor slowing down. It is estimated from the potential growth in the economy, being the weighted sum of labour and capital inputs and 'total factor productivity' growth. TFP is the statistical residual that remains after the growth rate has been explained by additions to the capital stock and to the labour force. The output gap measures the pressure on capacity in the domestic economy as a whole. It is a wider measure than deviations in unemployment from NAIRU that only measures the pressure of demand in the labour market.

Both provide only a partial explanation of inflation – demand-pull inflation pressure generated at home. They ignore cost-push inflation that changes the trade-off between the pressure of demand and the rate of inflation. Most cost pressures are external, the obvious ones being currency movements, competition from low cost developing countries, commodity and oil price changes. But structural reforms that increase competition also affect domestically generated cost-push pressures, such as those that weaken organised labour's bargaining power or reduce producers' monopoly power. Such reforms are widely ignored in the construction of short term forecasts. Their effects emerge too gradually to matter looking one or two years hence. But they accumulate over a decade to become of great significance. The comparison between Britain's low NAIRU and the French and German high ones demonstrates the importance of reforms (thank you Margaret Thatcher).

The shift from money and credit to output gaps and NAIRUs would not matter were the former important ingredients in real GDP forecasts. They are not. Side-lining money and credit is understandable. Over the long term the growth in the money supply and in nominal GDP are clearly correlated. But on the short-term horizon over which monetary policy is formulated, money growth can sadly be a misleading forward

indicator. The velocity of circulation can swing quite wildly. My former colleague, Professor Tim Congdon said in early-2001 that forecasts of a US recession were 'ridiculous' as money growth was far too rapid for one to occur. Instead the velocity of circulation plummeted. Each extra dollar did less work. A balanced view must be that 'money matters' but not that 'only money matters'. Thus the current central bank stance, that 'money barely matters', has led them all to ignore recent money and credit growth in excess of anything compatible with their inflation stances. (See letter to *The Financial Times*, 27 September 'Higher rates may be needed to contain inflation' from Tim Congdon and others.)

Amongst official forecasters, the OECD, IMF and most governments, money and credit have never been in fashion. Almost all forecasting models give them at best an extra's non-speaking role. They certainly have never occupied centre stage. What I want to do here is explain the mess we are now in, with unprecedented national and global financial imbalances, in terms of the failure to recognise that money does matter. In this I think I am in keeping with the ERC's worthy tradition. When real growth forecasts go awry, so does policy – except through accidents of timing and lags. There are problems with Keynesian-style real growth models. For one, they are short-sighted. They can't look much further than six to eight quarters into the future and often not that. Multipliers and accelerators interact to keep going whichever way they started. Pushed too far ahead and growth either explodes or implodes. I liken this to rowing a boat with your back to the future believing you are going where you have just been. So forecasts are designed to home in on trend growth after a couple of years. This is particularly evident when comparing IMF and OECD short term forecasts of up to two years with their medium term 'assessments' or 'scenarios' looking five or more years ahead.

It is worth spending a moment considering the OECD's medium term scenario. The latest looks five years beyond its short term 2007 forecasts to 2012. Short term forecasts are driven by demand. Medium term prospects tack on potential supply-driven extensions. The OECD assumed that in 2012 real GDP levels will equal their potential levels with no output gaps. This implies growth will equal potential between 2007 and 2012 plus or minus whatever is needed to close 2007 forecast negative or positive gaps. The implication is that domestic demand-pull inflation will neither be accelerating nor slowing down in 2012. But what about cost-push inflation? That too is assumed to be neutral. Nominal exchange rates are assumed unchanged at current levels, as too are real oil and commodity prices. Any

effects recent changes may have in the short term have long passed out of inflation projections by 2012. But at what rate will inflation be stable? Here the OECD finesses the problem by assuming central banks' policy will be successful in hitting inflation targets, mostly around 2%. Finally fiscal policy is also assumed to remain unchanged except for already announced changes (like the German VAT hike) that can plausibly be expected to happen. Not surprisingly, the business cycle is abolished and the world enjoys sustained non-inflationary growth as far as the eye can/can't see.

## The Malign Developments of Financial Imbalances Accounts for the Benign Development of Real Economies

Apart from money and credit, there is a related missing element in all this – sector financial balances. The broad sectors are households, private businesses, the public sector and 'overseas' or foreigners. Financial balances are the differences between each sector's savings and investment. This difference measures the extent to which each sector lends to (a financial surplus) or borrows from (a financial deficit) other sectors. Put another way, this is the difference between total sector spending – consumption plus investment – and total sector income. The current account of the balance of payments with sign reversed equals the overseas sector's financial balance. A current account deficit is an overseas sector's surplus. In theory sector financial balances sum to zero – although the estimates normally include residual errors. For every borrower there must be a lender.

Monetary and fiscal policy change sector financial balances. Fiscal policy directly alters the public sector's surplus or deficit. Fiscal ease – tax cuts and spending increases – make the public sector balance worse. Monetary policy operates through the private sectors. Easing makes credit cheaper or more plentiful and encourages households to consume more of their income and companies to invest more. Both lend less or borrow more – reducing assets or building up debts. So there is a direct link between money and credit and financial balances. Any change in one sector's financial balance must entail changes in some or all other sectors' balances. There are always second and subsequent round effects. More private spending increases the government's tax take and sucks in imports to the benefit of the overseas sector. Growth overall is driven by the extent to which sectors are able or willing to run financial surplus or deficits. Deficits generate debts that may become excessive. The borrowing and spending then has to stop. (Asset prices play a significant role in this story.) A current account deficit is

constrained by foreigners' willingness to lend to finance it. The currency crashes when they refuse.

The OECD forecasts and scenarios include projections for public sector and overseas (current account) financial balances. The private sector's balance is the sum of these with sign reversed. But the OECD does not project the balance between businesses and households. This however can be deduced from other elements in its projections – notably residential investment that is mostly households' and household consumption and savings. When the implied financial balances in the current OECD forecasts and scenarios are deduced, the results are wildly implausible.

Today there are unprecedented financial imbalances within and between economies. Their correction threatens to pitch the world into recession. (I hate the modern definition of a 'recession', two back-to-back quarters of falling GDP. I use the word rather loosely to mean significantly below-trend growth. If world growth fell 2% below its 4% trend that would be a global recession.) US imbalances are the most critical for the world and much that follows is concerned with them. The US current account deficit is the largest on record. It is passing through $800bn and headed towards $1 trillion. It is nearly 7% of US GDP and 2½% of the rest of the world's nominal dollar GDP (measured at current exchange rates not PPP rates). An overseas sector surplus so large means that the domestic US sectors collectively run a deficit of 7% of GDP. Very broadly speaking, the US government deficit accounts for around a third of this. The business sector is running a larger surplus than is normal, about equalling the government deficit. In consequence the household sector deficit is enormous and approaching the size of the overseas surplus. (It exceeded it in 2005 when the current account deficit was a shade over 6%.) It is without precedent for American households to borrow and spend more than their income to such an extent and consequently they have been running up unprecedented debt/income ratios. American households have stopped saving. They could only have done so because credit was cheap and plentiful.

Other countries suffer imbalances, Britain for example, although not generally on the same scale. For the moment these will be ignored. The global economy has enjoyed a period of strong and stable non-inflationary growth for the last few years and the OECD projects it to do so until at least 2012. Yet the stability of real economies has been a direct consequence of the emergence of unprecedented financial imbalances. Had the US consumers not stopped saving, had the US current account deficit not soared, the world economy would have remained mired in recession.

The malign development of financial imbalances accounts for the benign development of real economies. The OECD projections are implicitly the persistence and increase in malign imbalances. The US deficit continues to rise. American households continue to spend $107 for every $100 of income. No asset price forecasts are provided, but for the credit explosion to continue unabated they must increase in the future as they have in the past. The future will not and cannot be so naïve an extrapolation of the past.

## The Eurasian Savings Glut …

Before considering the consequences that must follow when these imbalances are reduced, it is necessary to examine how they emerged in the first place. Until a couple of years ago conventional wisdom blamed American government and consumer profligacy. In 2004 my Lombard Street Research colleague Charles Dumas switched the emphasis to developing Chinese, Japanese, Asia and mid-European thrift, which he dubbed the 'Eurasian savings glut'. (When Ben Bernanke came out with the same thesis a year later he was publicly credited for it.). It is easy to see which thesis is correct. How could American profligacy cause Eurasian thrift? How could Eurasian thrift cause American profligacy? If the former, it would be by causing inflation leading to historically high real interest rates. If the latter, it would be by threatening deflation and causing historically low real interest rates. On this count the savings glut thesis wins hands down.

The savings glut was an accident of history for which there was no single cause. The biggest savers (running current account surpluses) are China, Japan and Asian developing countries, joined since 2004 by OPEC as oil prices have soared. Chinese high savings are structural, the current account surplus due to the partial transition from controlled to market economy. Both are founded on an inadequate financial system, coupled with the lack of a welfare state. Chinese gross savings approach 50% of nominal GDP. The government chips in 10%, state and private enterprises 20% between them and households another 20%. As household disposable income is around two-thirds of national income, household savings are around 30% of household income.

Households' high savings are partly due to the single child policy, the movement of youngsters to the cities, the lack of pensions, unemployment assistance and health care. But they also reflect the lack of inter-generational banking intermediation. Paradoxically older Americans were very big savers.

This is shown by the size of the US financial industry with its huge banks, insurance industry and money managers. These institutions mediate between those who save and lend and those who borrow and spend. Younger Americans borrow and spend. Most of the older generation's savings are intermediated to the young. They cancel out within the household sector's financial balance. The fall in US household savings to zero is largely because older Americans have stopped saving. They have made so much money from the rise in the value of their assets, notably houses, they have no need to. In China, lacking intergenerational intermediation, both the young and old save.

The same factor partly explains high Chinese enterprise savings. Private enterprises have difficulty in obtaining bank or market credit. State enterprises obtain command loans from state banks. But they also make substantial profit (ignoring depreciation) from no taxes, low interest rates and never needing to repay loans. The old communist command economy had no difficulty in absorbing high savings. It was wonderfully efficient at wasting money in value-subtracting production and unprofitable over-investment. Companies could not go bankrupt as liabilities could never exceed assets. Under communism, assets cannot be market-to-market as there are none. Old loans could always be repaid with new. Profit was a meaningless concept. Bank deposits grew rapidly out of savings that were paid a pittance in interest. But the saver had nowhere else to go. Command loans supported communist party officials in power.

The transition to the market economy changed that. Private enterprises can go bust. They have assumed sufficient importance that the business cycle now matters, driven by the investment accelerator principle. (The rate of growth in investment is a function of the change in the rate of growth in sales. If sales double in a given time period, they must double in the next to keep the growth in investment unchanged.) So a new way had to be found of wasting excess saving – lending it to Americans.

Japanese high savings are secular, the fall-out from the 1990 burst stock market and real estate bubbles. Japanese imbalances result from excessive business savings. Business top-line profits account for a quarter of GDP. Some 15% is used to finance investment, leaving a financial surplus of 10% of GDP. This has its counterpart in the overseas and government deficits. Japanese household savings have meanwhile been declining as rapidly as American and the household sector has recently moved into a small financial deficit. Had it not been for the budget deficit, the current account surplus and the collapse in household savings, Japan's decade in

the doldrums would have been one of outright depression and soaring unemployment. Big top-line profits have been necessary for corporate survival. They have disappeared down a black hole of stock market and real estate losses, bad loans and pension fund top-ups. During the 1980s bubble rising asset prices fuelled a 'merry-go-up' during which bottom-line profits exceeded top-line and were squandered in over-investment, purchases of old masters and American real estate. Surplus savings were successfully wasted. Falling asset prices caused a 'misery-go-down' as these forces were reversed.

The other Asian countries' savings glut is political. It came on the heels of the 1997 Asian crisis. Foreign borrowing fuelled over-investment and currency over-valuation. Resisting appreciation, foreign currency reserves soared. This induced a false sense of security. Economies boomed and overheated. Imports were sucked in and current accounts plummeted. Sadly much of the foreign capital inflows were banking flows, loans denominated in foreign currencies. Again this reflected immature domestic financial systems. Foreign loans were cheaper and more plentiful. But with the exploding current account deficits and over-investment, confidence in currencies evaporated. Capital inflows reversed with a vengeance. Currency reserves rapidly ran out. Current account deficits could no longer be financed and had to be abruptly reversed. The authorities were on the horns of a dilemma. Raising domestic interest rates to defend currencies would bankrupt domestic currency borrowers. Letting currencies fall would bankrupt foreign currency borrowers. Egged on by the IMF, both resulted. Real GDP plummeted, correcting current account imbalances and leading instead to substantial surpluses. The experience was traumatic. Authorities vowed that they would never let it happen again. They pegged currencies, helping to create the 'new dollar area, became mercantilist, ran persistent current account surpluses by keeping a tight grip on domestic demand and rebuilt reserves. Asian investment remains subdued and at a level regarded by the IMF as low for developing countries.

Oil producers' surpluses are inertial, the direct product of soaring oil prices. They account for much of the recent increase in the savings glut. When the value of oil exports rises by 30% to 40% of GDP over two years there is no way that domestic spending can rise at a similar rate. It will take time before imports can catch up with exports and possibly they never will if oil prices remain at current levels. OPEC countries also have bad memories of spending overnight riches only to have them taken away when oil prices slumped. Oil prices will not remain at recent peak levels

although they could stabilise at levels significantly higher than in the past. Today the savings glut is firing on all four cylinders – Japan, China, Asia and OPEC.

## … Met Rising Returns to Capital in America

A marriage requires two willing partners. The rest of the world could not save and lend if Americans had been unwilling to borrow and spend. Why did they do so? There were other forces at work as well as the savings glut. Globalisation and the IT revolution were the most important. The dominant factor in globalisation was the addition of a massive pool of cheap labour to the world market economy from China in particular. Outsourcing drove down traded-goods prices and deprived developed countries' producers of their pricing power. It also reduced labour's bargaining power. Ironically reverse outsourcing of financial intermediation from China and other savings glut countries has lead to substantially higher incomes and profits amongst global, largely American, financial institutions. China runs a current account surplus and thus cannot be a net international lender. But it also receives private capital inflows. The US deficit and Chinese capital inflows are financed from private Chinese savings. Thanks to the pegged yuan, these are financed by government borrowing to pay for soaring dollar reserves. Hence Chinese savings go out, pass through the US financial system, and come back in the sale of products and assets to Americans. This outsourcing contributes to American employment and growing income inequality. It also underwrites profits with the financial sector making a significant contribution to Wall Street's strength.

The rise in the global supply of labour relative to capital increases the returns to capital helping to raise asset prices relative to labour costs. The IT revolution increases the productivity of capital. The price of capital goods has been falling, the more so at constant prices especially when valued using hedonic accounting. 'More bang for each buck' has reduced the share of investment in world real GDP. It has meant that conventional depreciation charges exceed the cost of replacing worn out capital equipment, leaving companies with more cash in their pockets. The savings glut reduction in nominal and real interest rates has meanwhile reduced financing costs. Consequently companies are enjoying unusually large financial surpluses. The IMF has shown that *ex ante* global investment has fallen rather than global savings increased.

## Leading the Federal Reserve to 'Validate Asset Price Inflation' in Preference to a Deflationary Slump

None of this would have happened had the US not filled the savings-glut hole in *ex ante* global demand. How so? The world experienced a structural shock that changed both the level of demand (the savings glut) and the relationship between demand and inflation. Central bankers, especially the Fed, were faced with a demand and price deflationary shock. Monetary policy is ill-equipped to handle changes in the relationship between demand and inflation. It operates on the assumption that demand and inflation are positively correlated. If the current situation is correctly reflected by the latest statistics and the future development of demand can be reasonably projected (both big 'ifs' especially given big statistical revisions to the present and past) monetary policy is obvious and unambiguous. Shocks pose dilemmas. The 1970's oil shock was price-inflationary and demand-deflationary. Central bankers (and government fiscally) had to choose between easing to validate inflation and protect jobs or negating inflation at the expense of recessions. The Arthur Burns Fed in the 1970's chose validation. The Paul Volcker 1980's Fed opted for negation.

The dilemma posed by the savings glut-globalisation-IT shock was initially more complex. In essence it was whether to validate or negate asset price inflation. The former was bound to be the preferred option given the possibility of a deflationary slump. The Greenspan Fed did not cause the late 1990's dot-com bubble on Wall Street. But it assisted by temporarily easing monetary policy in the wake of the 1997–98 Asian-LTCM-Russian crisis. Alan Greenspan lent moral support as the cheer-leader for the new economy. When that bubble burst, capital investment collapsed and the US headed for a dangerous recession. In the event the 2000–01 recession (or slowdown depending on the latest quarterly GDP revisions) was mild. Greenspan plunged the Fed funds rate into a 1% chasm and helped inflate the housing price bubble. Tax cuts assisted as the budget moved rapidly from surplus to deficit. Dot-com trashed company balance sheets were restored to health at the expense of trashing household and government balance sheets. Unprecedented financial imbalances followed.

It is hard to see how the Fed could have acted differently. Unlike other central banks it is not given an unambiguous remit to control inflation. It is tasked by the Federal Reserve Act with potentially conflicting goals - "maximising employment, stable prices and moderate long term interest rate". It could not pursue a high interest rate policy or raise rates in order to moderate or deflate asset price bubbles at the expense of growth and

employment. Indeed asset price increases were one transmission mechanism by which monetary ease supported consumption and investment. American median real income was stagnant as inequality increased, widely blamed on globalisation. Consumer spending could only be bolstered by falling savings. Rising housing wealth became the surrogate for rising incomes, providing the wherewithal to borrow cheaply and service rising debt/income levels without debt-servicing/income levels increasing.

The Fed also had an intellectual argument supporting asset price appeasement. It could not second-guess markets. But this is a copout. The factors cited above called for a stepwise rise in asset prices, but not a persistent asset price rise. People can reasonably disagree about whether asset prices are a bubble. But asset prices are only one side of balance sheets. One can hardly contest debt bubbles on the liabilities side bred by financial imbalances.

Had the Fed tightened earlier, would it have made any difference? The Fed's policy rates are limited to the short end. Markets determine longer rates and risk margins. When the Fed dropped into its 1% chasm, 10-year and longer rates eased but not significantly. When it resumed a measured increase in policy rates towards normal levels, market rates continued for a while to decline. This so-called "conundrum" was nothing of the sort. US market rates are driven by global liquidity and the savings glut continued to hold them down.

The Fed lost control over market rates while, at the same time, was unwilling or unable to control the growth in money and credit. Money is mostly bank deposits and credit mostly bank loans. As defined, their growth rates can differ. Only domestically-owned bank deposits are counted as 'money', akin to the Sterling M3 set by the IMF as a target for UK money growth under Denis Healey's Chancellorship. But foreign-owned deposits are important, boosting total deposits. Deposits permit advances and advances create deposits. Under BIS rules reserve asset holdings against eligible liabilities constrain the expansion in banks' balance sheets – expansion that boosts profits. Reserves can be augmented from retained earnings and new capital obtained from the markets. When business and banks' share prices are buoyant, the reserve constraint is relaxed and credit can easily grow at double digit rates – distinctly faster than defined money growth. Moreover share prices are driven in the short term by excess liquidity. Booming loans to other financial institutions finance leverage and propel speculation. The growth in derivative trading adds impetus. Supposedly it spreads and hence reduces individual risk. This is the view taken by the Bank of England. But

it is a fallacy of composition to suppose that it reduces systemic risk. The analogy is with a poker game. The winners take money from the losers. But if hundreds of others gamble on the outcome, the winnings and losses are vastly multiplied. Equally, the growth rate in credit to the non-financial private sector can readily exceed that of the defined money supply.

## The Medium Term – Unwinding Bubbles and Imbalances – but not Inflation

The initial price and demand deflationary shock permitted an increase in money and credit that fuelled growing domestic and international financial imbalances. The US policy of savings-glut appeasement, coupled with generally low real interest rates everywhere, led to world boom in which China has taken a leading role. Its economy uses fuel and commodities inefficiently. Relative to GDP it is a greater gas-guzzler than the US. Hence world oil and commodity demand rose more rapidly relative to booming world GDP than in the past. The deflationary forces from falling traded manufactured goods price were swamped by the inflationary rise in oil and commodity prices. The boom restored labour's bargaining power and producers' pricing power. 'Core' inflation, targeted on various measures, became a flawed lodestone. The problem facing central bankers reverted to the 1970's price-inflationary/demand deflationary dilemma. They have responded to negate inflation by raising interest rates. Market rates have followed suit as savings-glut pressures have subsided in the wake of the boom.

IMF and OECD benign projections assume malign financial imbalances get worse. But their analysis of the downside risks to their politically correct forecasts indicate that they do not themselves believe them. The most optimistic scenarios they examine assume that imbalances can be gradually reduced. The world then experiences a soft landing on trend growth. This is possible but highly implausible. Monetary tightening can no longer be relied upon to have a smooth braking effect. Bubbles do not gently deflate, they burst. Raising interest rates is akin to pushing a stick between the spokes of a cycle's front wheel. Nothing happens until it makes contact. The rider is then pitched over the handlebars. Under these circumstances a global recession is unavoidable. The US role as importer of last resort is nearing its end and as US domestic demand falters imports will fall. The current account deficit will not go on increasing, as is commonly supposed. It will surprise with the speed at which it diminishes. The burden of weakening

US domestic demand will fall as much on foreigners' GDP growth as on American. Incipient inflation will be nipped in the bud.

### Currencies, Interest Rates and the Stock Markets

Where does this leave currencies, interest rates and stock markets? The dollar's medium term prospects are strength rather than weakness. Americans will stop borrowing and spending before others wish to stop saving and lending. US GDP will hold up relatively well as net exports contribute ½% to 1% to growth instead of deducting a similar amount annually since 1993. The main change will be versus the euro. Japan is well placed to weather the storm and the extremely under-valued yen looks like bucking the tide and strengthening. The Chinese refused to revalue the yuan when its economy was overheating. It won't do so when it suffers a hard landing.

Interest rates generally will fall and bonds will be the best bet, except for within Euroland. The strains imposed by the single currency are bound to become more acute during a world recession in which US imports fall. Stock markets cannot avoid collateral damage – as in 1987 – from Wall Street's retreat. But some will recover quicker than others, notably the Nikkei.

### And Beyond That?

Looking further ahead, this promises to be a global business cycle downswing. It is not the beginning of a global recession. China must replace lost export demand with domestic. The command element in the economy remains strong and substantial infrastructure investment is needed. A retreat from the market economy to the old highly efficient ways of wasting surplus savings is politically inevitable. In Japan company savings will take the strain. Asian economies will benefit, given time, from Sino-Japanese resilience. Oil and commodity prices will retreat and OPEC surplus savings diminish. Structural, cyclical and political forces are at work to eliminate the world savings glut. Looking to 2012 the impact of ageing on developed countries' savings, not least Japanese, will be significant. Globalisation and the IT revolution will no longer be so shocking. Imbalances will be greatly reduced. This benign medium term outlook, following a period of stormy weather, is predicated on the hope that the US and world will not relapse into protection. It also assumes the geopolitical scene takes no turn for the worse.

I have now made it to over 5,000 words. Given the greater economic

expertise of other members of the ERC, I hope this makes some minor contribution to the 75th anniversary commemorations. But I cannot end without a disclaimer. Many of the ideas expressed in this paper derive from my colleagues at Lombard Street Research, notably Charles Dumas, Gabriel Stein and Diana Choyleva. But of course they cannot be blamed for my errors.

## HOUSING POLICY FOR THE 21ST CENTURY

*Extracts from a talk given by Nicholas Boles, Director of 'Policy Exchange', a think-tank with close links to the Conservative Party, to members of the Economic Research Council on Wednesday July 12th 2006*

Our homes are expensive: prices in the South have risen faster than earnings, so millions of people are unable to afford the standard of housing their parents could, even though they are wealthier. Our homes are small: we have the third-smallest homes in Europe; while other countries are increasing the size of their newly built dwellings, our new homes are the smallest, and getting smaller. And our homes are old: nearly 40% of housing stock was built before 1945; Denmark and Spain are our only European neighbours with older homes.

So we live in homes that are costlier, smaller and older than almost anywhere in the world. And because the supply of land is highly constrained and there is pressure to build on brownfield sites, new dwellings are increasingly being provided in blocks of flats. As recently as 1990, only about an eighth of new dwellings were apartments, but by 2004 this figure was nearly a half.

But is it what we really want? According to a recent Mori poll, 95% of those questioned favoured a house of some kind, and only 3% wanted to live in flats. Another survey, financed by the Joseph Rowntree Foundation, last year found that, when asked about local development, people preferred houses to flats. The most disliked housing type was blocks of flats of four storeys or more, yet this is what is being built.

For many years there has been a consensus that the building of high-rise housing estates in the Fifties, Sixties and Seventies was a huge mistake. Not only are they unpopular, hard to maintain and breeding grounds for crime; there is also a broader critique which argues that residential accommodation of this size and scale is dehumanising. Recently, however, the tide has started to turn. There is a new vogue for commercial skyscrapers in London, energetically promoted by Mayor Ken Livingstone who, with characteristic understatement, describes opposition to these new towers of commerce as the biggest threat to the economy of London since Adolf Hitler. Already there are indications that an unholy alliance of developers, politicians and architectural trendies is seeking to extend this fashion into the sphere of housing provision, in clear contradiction to the wishes of the public.

None of this inner-city megalomania troubles most of the defenders of the status quo – owner-occupiers, conservationists, nimbys. They are all too happy for the tower-block utopians to provide an intellectual justification for this development craze, giving cover to their own rather more selfish arguments against building on greenfield sites. But these arguments are hoary myths that are ripe for debunking.

Rising house prices are not the boon they appear, and benefit only a minority (downsizers). For others, rising prices prevent them from buying or renting accommodation of a similar size and quality to that which their parents could afford. There is a macroeconomic impact, too, as constraints on housing supply accentuate the instability of the economy and make Britain a less attractive place to do business.

Groups such as the Campaign to Protect Rural England argue that we live in a small, overcrowded island and that we should build denser towns and cities to 'save' the countryside. Yet only 8 per cent of land in Britain is urban, half the figure in the Netherlands (which nevertheless builds new homes 50% bigger than the UK's) and also less than Belgium, Germany and Denmark. Meanwhile, 78% of British land is in agricultural use, more than any other EU country.

We calculated that if we only used a quarter of the non-urban land at densities commonly found in continental Europe, this area alone could accommodate more than 73 million people. In other words: It is completely absurd to assume that England would soon disappear under concrete. In fact, the Office of National Statistics suggests a population growth of 7.2 million for the whole of the UK until the year 2031. To house these people would thus need less than 2.5 per cent of the non-urban land of England.

Any claim that we are actually running out of land is simply ludicrous.

The anti-development lobby also argues that its stance is better for the environment. But research in Germany has shown that low-rise, low-density housing is actually better for the environment than monocultural farmland. According to the Royal Horticultural Society, 'gardens are England's most important nature reserve', but we are building all over them in order to save green fields which are farmed to promote one species at the expense of all others.

How many suburbs – composed of exactly the kind of green, low-density housing that is best for the environment and preferred by the public – have been despoiled in recent years by infill developments? Instead of building outwards and creating new suburbs we have presided over the eradication of acre after acre of allotments, playing fields and large gardens in existing suburbs. It's a safe bet that those suburbanites who owned the land that was bought by developers didn't hang around. Their windfalls were probably invested in country estates or Tuscan villas.

We know through biological research that plants and animals thrive in low density urban environments. They provide the gardens, parks and playing fields that plants and animals need. Where, however, densities are high or the land is used for industrial agriculture there is a massive drop in biodiversity. This explains, for example, why butterflies and moths are disappearing in England. It is not, as some environmental campaigners want to make us believe, the effect of climate change but simply because the habitat of these species has been concreted over – within the cities. If you really care about biodiversity and the environment you are best advised not to protect agricultural land, which often enough is a biological desert, but to build cities with lots of green spaces. If this consumes some formerly agricultural land, so be it.

Green cities are not only better for the environment; they help humans lead healthier lives. The health benefits of green cities are well documented. The World Health Organisation, for instance, found that there is a clear link between obesity and the level of greenery. It is not difficult to understand why. Where there are parks and gardens, people tend to be more physically active. The benefits do not end there. Urban trees provide oxygen and moisture, and effectively regulate the microclimate.

The pattern that has emerged from our research is clear: Green cities, cities with lower densities and lots of space for gardens and parks, are desirable from every perspective. Plants and animals prefer the green, low-density cities over every other kind of settlement. And so do human

beings, as opinion polls show. The majority of us want to live in houses that are spacious, have gardens, are situated in green suburbs, and which allow a sense of privacy. But with house prices rising excessively, government targets of densification and campaigns to stop urban development, these goals cannot be achieved for large parts of the population.

The current planning system is failing to provide the kind of settlement pattern that is good for humans and nature. Quite the opposite in fact – it has been captured by vociferous organisations like the Campaign to Protect Rural England (rightly relabelled by Martin Wolf as the Campaign to incarcerate Urban England) to deny the majority of the population a decent standard of life in order to preserve that of the few inhabitants of rural areas.

Our Soviet-style planning system has meant that the standard of architectural design has also suffered. We are confronted with the rotten fruits of postwar social housing every day, but a system that constrains supply is also one that discourages design and innovation. Such is the level of unsatisfied demand for housing that whatever is built sells. Design comes a distant second to the pure physical fact of having a place in which to live. Some of the new developments in the Thames Gateway area – heralded as a major zone for housing growth – are little better than prefab rabbit hutches with Legoland features. Not homes for heroes but homes for zeros.

Continental housing is much better than housing in the UK. It is more spacious, delivered faster, designed better and costs less. The obvious question is why that is so. Do other countries have better planners? Are their architects more creative? Do their builders work more efficiently? Or is some other factor at work?

To find the answer, Policy Exchange recently completed a detailed piece of comparative research in two countries that derive their planning systems from the British model (Ireland and Australia) and two countries that operate a decentralised zoning system (Germany and Switzerland). The results leave little doubt about what is to blame for the British housing crisis.

The culprit is the planning system. Wherever British-style top-down planning has been tried, it has failed miserably. Ireland, for example, needed lots of new housing quickly to keep up with shrinking households and growing immigration during the boom years. However, planning for development started too late and then only produced units for the bottom end of the market – a quick fix that is already creating problems for homeowners wishing to trade up.

Australia is an even better case in point. In spite of being a continent-sized country with a population of only 20 million, in its state capitals land accounts for between 50 and 80 per cent of the price of a small family home. This is mainly due to state government policies of restricted land supply, densification and imposing infrastructure costs on developers. Common to both Ireland and Australia are exorbitant house price increases – an indication of an unresponsive supply side. Furthermore, both countries rely on local planners who have hardly any incentives to support development. Local budgets are not determined by the results of local policies but largely rely on central government grants.

In contrast to this stand Germany and, especially, Switzerland. Both countries are building new houses that are on average 40 per cent larger than their UK equivalents, and both have enjoyed three decades of stable property prices in real terms. Planning is mainly done at the local level, where budgets depend on factors such as population figures, tax revenue generated, or even local income taxes. It is precisely because of this that local planners are keen to support their councils by making their cities attractive places to live, and thus attractive to new inhabitants. People get the houses they want and the politicians are the masters of their own (fiscal) fate. Existing residents benefit, too.

There are thus two obstacles to the delivery of better and affordable housing. The first is, unsurprisingly, the planning system itself. The second is the way local government is funded. We believe that it is vital that both these systems are changed at once to achieve better results.

For the planning system, it is important that a much higher degree of flexibility is achieved. This means abolishing plan-led development, which blocked desirable, but not previously anticipated, development in the past. In addition, we would like to see a genuine presumption of a right to develop. It should be for local communities to demonstrate why a new development is not desirable, not the other way around. Thirdly, the current system focuses too much on the social costs of development. We would put much greater emphasis on the economic benefits of development and give weight to them in the planning process. In addition to these major changes, some additional adjustments to the planning system could be made. For example, land buffers should be integrated into plans, switching between designated uses (residential, commercial etc.) should be simplified, and last, but certainly not least, the role of local governments should be strengthened in the planning process.

Our research in other countries has shown that planning works best

where local communities are in charge of their own affairs. However, only putting communities in charge will not do. They must also have the right incentives to engage in pro-active planning. There are several ways in which this could be achieved. The most straightforward would probably be to give them a greater autonomy over taxation. Such a system works very well in Switzerland where it has kept both taxation levels and house prices low. However, under the current British system of local government finance such a seismic shift would be hard to achieve, and this is why we have also put forward a second-best solution: the Social Cost Tariff (SCT). An SCT of £500,000 per hectare could replace all existing charges such as section 106 agreements and provide extra incentives to encourage communities to develop. Instead, councils would only be given a minimum building target by central government. But if they built more than that, they would keep the receipts from the SCT. This would provide an incentive for local communities to plan for development and would compensate them for the costs of that development.

I believe that implementing both reforms – of the planning system and of local government finance – would make the supply of housing more flexible and deliver the kind of well-designed, spacious, affordable housing in green cities which the citizens of Germany or Switzerland take for granted.

## BUSINESS AND INVESTMENT FOR 2007

*By Damon de Laszlo*

While it is the most popular job of the journalist and the pundit to issue dire warnings of doom and gloom on a daily basis, those that have to manage businesses and take decisions about investing in the future can only be successful if they consider and analyse information and look for signs of changing trends. This is the difference between noise and information.

Around the world there seems to be a marginal slowing of economies in Asia but nothing that could be called significant, and the same goes for the USA. Russia and Japan continue to pick up their pace of activity, and Europe remains as a unit a sort of quagmire of conflicting trends producing virtually no direction of any kind.

The biggest trend seems to be the world's Central Banks' feeling that they need to raise interest rates. A sort of Central Banks' herd instinct that once they have got to the bottom they have to climb back up the hill. This movement in itself is slow and as long as the rate of change remains slow, it should not derail the world's economy.

In the macro sense, there seems to be a continuing integration of the world's economies, talked about as 'globalisation'. It is this globalisation that is stabilising individual economies as the actions of even the largest economy in the world, USA, has less impact on global trade than it used to. It is global trade that is going to be the overriding phenomenon of the still-new millennium. The extraordinary rise in the movement of commodities and goods from one market to another across the Atlantic and the Pacific can be measured most simply by noting the bottlenecks in shipping in the major ports of the world.

The other major change that slots into the new millennium and gathers pace is the incredible increase in productivity in all forms of production. The application of electronics and computers by engineers who started senior school in the 1980s, who regard the computer as the core of any system and the impact of this on machinery is so ubiquitous that it is difficult to quantify.

The manifestation of this in America is the continuing extraordinary increase in productivity, output per unit of labour, which in this flexible economy is generating all kinds of jobs and the country maintains its low unemployment record. The same effect in Germany is showing increased industrial production alongside high unemployment as the lack of flexibility in the country's employment rules and regulations in general make it difficult for the development of new businesses. Thus increasingly flexible equipment is starting to have some interesting side effects. Small amounts of production are moving back from the cheap labour areas of China to the West, as the improved productivity enables hugely increased flexibility in production, shorter lead times and shorter runs. In some areas this has advantages over the long lead times required to manage the long supply chains and shipping costs of manufactured product, and shipping it half way around the world from Asia to the West.

On a completely different front, another interesting trend in the financial markets over the last few years has been the phenomenal growth in so-called Hedge Funds. This growth has been encouraged by regulation in the main financial centres that restricts the flexibility of a manager to manage money. The Hedge Fund today is in reality any fund that is unregulated.

By contrast the regulated funds are managed within the financial centre rules and while they are typically long only, do indulge in buying so-called structured products and indexes.

The distinction, apart from fees, between Hedge Funds and Long Only investment management is becoming rather like the distinction between hardwood and softwood.

Many people think that this description describes the texture of the wood, while in fact softwood is a tree that has needles and cones, whereas a hardwood is a tree with leaves. Some hardwoods are very soft, and some softwoods are very hard!

Hedge Funds today control such vast amounts of money that they do affect not only the stock market but also the commodity markets. In the last few months, we have seen commodity prices falling, possibly having been too high, but the underlying shortages have not changed.

In the Stock Markets, the malaise seems to be due partly to the liquidation of stocks by pension funds where government and regulators have for some years now been confusing investment decisions, and Hedge Funds who are unconstrained by consideration of Capital Gains Tax or any regulation, and tend to follow each other in and out of the market.

Whatever the medium and longer term may bring I am optimistic that by the time we get to the end of the year there will be a point at which the market will have started to move higher and then suddenly there will be a rush to be invested, driving it up again possibly to above trend heights.

## ENERGY SECURITY IS THE GREATEST WORRY, NOT CLIMATE CHANGE

*By Dan Lewis*

Britons fear global terrorism far more than climate change, a sensible assessment which should be reflected in energy policy. Today's major terrorist threat – Islamic fascism – is ultimately funded by what many wrongly perceive to be the greatest environmental threat – oil. Only by putting energy security ahead of environmental concerns can we achieve worldwide democracy and the cleaner, cheaper and more bountiful energy that the world demands.

It is an inconvenient truth for Britain's commentariat that voters don't agree with Sir David King or Al Gore that Climate Change is the greatest threat to our existence. According to a poll conducted by Populus for the Stockholm Network, it ranked fourth after international terrorism, third world disease and third world debt and poverty. With this July's heatwave now a distant memory, we find ourselves in the midst of a chilly, dark August and a failed terrorist plot unimaginably sinister in its scope.

Recently a Spectator/YouGov poll suggested that Britons' views on terrorism are hardening. There is indeed wisdom in crowds that recognise scientists' complete inability to predict Britain's wettest May in 27 years, the coldest February and March for nine years and August daily sunlight hours running at less than 50% of the average. The same people however have clearly discerned a tangibly deteriorating security situation and are resentful of rising energy prices. Energy security – keeping the lights on and the country moving – is therefore a crucial objective.

Britain's indigenous oil and gas supplies in the North Sea are running out and nuclear and coal plants – around 60% of our electricity generation – face decommissioning in the next 15 years. The worrying economic backdrop is that the price of oil has reached a new comfort zone at above $70 a barrel. At the same time, Western soldiers most often face an enemy ideologically trained by extremist Madrassahs funded by Middle Eastern petrodollars.

Yet we refuse point blank to face up to the root cause of our security woes: the annual transfer of billions of dollars to pay for our energy resources to nations who then use these funds to undermine liberal democracy abroad and prop up their authoritarian states at home. As the price of oil has tripled in the last few years, this situation has worsened in countries

like Iran, Russia, Saudi Arabia and Venezuela. If oil were, say $15 a barrel, Iran almost certainly could not afford simultaneously to finance a nuclear weapons programme, the funding and arming of Hezbollah and Shiite militias and run the risk of crippling UN trade sanctions. It is also highly likely that such low oil prices would create massive levels of unemployment which would inexorably ferment unrest, possibly a revolution, making them far more responsive to both diplomatic and domestic pressure for reform, and eventually democracy and real prosperity.

Sadly for democracy, the oil price has gone the other way. Today's reality has been interpreted by the American best-selling author Thomas Friedman as 'The First Law of Petropolitics'. There is an inverse relationship between the price of oil and the pace of freedom. It is to this deteriorating background that the Economic Research Council published "The New Economics of Energy Security" by Sir Bernard Ingham, Professor Colin Robinson and Dr Eileen Marshall to explore how Britain could achieve energy security at a reasonable cost.

There is a good case for much more use of nuclear and renewables if the price is right. The irony of the Iraq War is that although the associated instability has raised oil prices, it in turn has led to an investment boom in alternative and nuclear energy which would not otherwise have happened to the same extent. Meanwhile, Brits are now looking across the channel and noting how there is no energy crisis and no record price increases in France where 75–80% of electricity is generated by nuclear power.

The ultimate benchmark for the success of alternative energy will have to be that it serves to reduce demand for oil and bring its price down, which would cut funding for many terrorist groups. In the shorter term however, Britain will not reap the benefit of greater energy security without substantial liberalisation of Europe's energy markets. As the UK finds itself at the wrong end of the gas pipeline, it will continue to suffer the highest gas prices in Europe. A major effort has to be made in Europe to accelerate cross-border trade in gas, creating greater liquidity and a stable price.

Sadly, too many of our politicians tiptoe around the relationship between oil, terrorism and the environment. Instead they are investing themselves in marginal if not irrelevant solutions like energy efficiency or distributed generation, which involves thousands of small power plants instead of a few large-scale ones. But the right way forward for the UK is a much greater emphasis on nuclear and alternative energy sources, a heavy dose of climate realism and liberalisation of the European energy markets. Only then will UK consumers have secure energy supplies.

## LIONS, DONKEYS AND DINOSAURS

*By Lewis Page Published by Heinemann, 2006, price £12.99*

'Everyone' said that I should read this book even though normally I would not expect to regard a book on Britain's armed forces, their organisation, equipment and costs, as part of my area of interests as an economist. 'Everyone' was right – I was profoundly moved, considerably enlightened, made angry with concern and hugely entertained. Make no mistake – this is 'a big one'.

There are numerous themes and this very short review cannot begin to cover much of the material. Essentially, much of it amounts to a reasoned claim that money for the armed forces is being mis-spent, that the economics of defence should be exposed and debated, that businesses involved in the supply of defence equipment operate in (shall we say?) 'surprising' ways and, in consequence, the organisation, equipment and costs of Britain's armed forces need desperately to be regarded as an area of interest for economists and research groups of all kinds. We spend too much time feeling indignant at the costs of the Common Agricultural Policy or the National Health Service and not enough – if any at all – about comparable sums used ineffectively and wastefully in the name of defence. And this isn't just wealth. It is lives lost.

So what is wrong? Procurement policy is too often dictated by rivalry between the 3 services – Army, Navy and RAF. Each, Page points out, seeks to maintain its arms of virile identity. The RAF seeks to maintain a long range bomber capacity, the Army wants main battle tanks and the Navy wants frigates, none of which, Page demonstrates, are the best use of resources in today's conflicts. Organisational restructuring must be undertaken. Politics has cost us dear – weapons of all kinds could have been bought at the 'going rate' from firms around the world at (often) a fraction of the cost of buying them from sources close to the hearts (and perhaps also the pockets) of politicians – such as European consortia or BAE. Economics seem never to be considered – the difference in 'marginal effectiveness' of each £1 spent in different ways can only make one weep.

Of course, one would like to know more. I would like to know Page's analysis of the planned Trident update (announced after the book was published). As an enthusiastic reader of Alan Clarke's 'Diaries' I would like to know how Page sees that particular Defence Secretary's work in

the general scheme of things. As a sometime historian I wonder how the need for reform today compares with previous efforts, with Cromwell's 'model army' or with Cardwell's army reforms following the Crimean War. Haven't we been here before?

The children's film 'Never Ending Story' has a fine finale which involves the reader in the actual story – the lad reading the tale has to take action to change the ending. Something similar happens when one reads 'Lions, Donkeys and Dinosaurs' – Page urges the reader compellingly, to take up his cause, write to one's MP and make change happen. It becomes an obligation, rather in the manner that the Japanese would understand by having an 'on' – a debt to someone who has helped one along life's way, which cannot ever be fully repaid but which one must nevertheless strive to. Writing to an MP is useful but urging others to read the book makes one feel a bit better also. For myself, as an alarmed onlooker, I want to wish Page every possible success in achieving wide recognition and influence for this book and for his interpretation of our defence predicament.

## DISAPPEARING BRITAIN:
## THE EU AND THE DEATH OF LOCAL GOVERNMENT

*By Lindsay Jenkins. Foreword by Lord Tebbit, Published by Orange State Press, 2005. Price £14.99*

Readers of Britain & Overseas will know that for several years I have expressed concern over the participation of the United Kingdom, and England in particular, in 'the European Project'. In the most recent issue of the journal I tried to get to grips with the proposed Constitution, which, though rejected by France and the Netherlands, seems to be pursuing its insidious path. As far back as Spring 1998 I wrote at length on 'Devolution and Regionalisation: the Outlook for England'. I traced back what the EU was doing based on a product of Hitler's Germany of 1942, Heinrich Hunke's Die Europäische Wirtshaftgemeinschaft – or, 'The European Economic Community' – with its single currency, and although noting that administrative regions had been organised in the UK as far back as the First Great War in order to organise the defence of the kingdom, the EU system of European regionalisation, and for which we had not voted, was designed

to break up England and to facilitate control of our country by Brussels. I also pointed to the system of 'frontier regions' about which no one seemed to know anything, all with healthy budgets – thus Nord-Pas-de-Calais/Kent, funded to the tune of £62,877,000, and East Coast of Ireland with Dyfed and Gwynedd, to which £94,222,000 had been allocated provided Ireland were the greater beneficiary. All this I found shocking especially because so much seemed to be being done surreptitiously.

Reading Lindsay Jenkins's detailed, meticulously supported account, my shock has turned to horror at what is being perpetrated. It is not simply that what has been done by the two Labour administrations since then, chiefly under the aegis of the Deputy Prime Minister, Mr John Prescott, has been manipulative but it has often been dishonest as a single example from many in Ms Jenkins's book will show. Because support for regional assemblies has been so poor (and was voted down in the north-east, thought to be the area most favourable to such a project), the government's 'sounding exercise' to whip up support for regional assemblies, begun in December 2002 but needing to be extended twice in order to whip up support, showed that only **two** of the respondents from the 960,000 electors of Hampshire were in favour. Yet, as the MP for the New Forest, Desmond Swayne, told the House of Commons, 'any response whatever is counted as interest in favour of a referendum. The fact that someone might be wholly against an Assembly … will nevertheless be counted as someone expressing an interest in a referendum'. As the MP for the Isle of Wight (Andrew Turner) put it, 'I am shocked and amazed at the implicit duplicity of Ministers'. Yet, Mr Prescott could declare that the consultation exercise in the South West had shown 'overwhelming public interest in the idea' (p. 73). By Regulation (EC) 1059/2003, 26 May 2003, the EU decided that every country must have EU regions. Further, there will be sub regions (populations 800,000 to 3 million), and sub sub regions (150,000 to 800,000), charmingly (but perhaps disingenuously) denoted as NUTS 2 and NUTS 3 respectively. These will fit what is called Brussels's 'Spatial Plan for Europe'. Thus, Devon County Council will be sub sub region UKK 43 and Dorset County Council UKK 22, *pending their abolition* (pp. 124-6).

Lindsay Jenkins gives far more detail than I can accommodate here, but her chapter 19 is especially worrying: 'How far is Germany implicated?' I have already mentioned the Huhn plan of 1942 (which Ms Jenkins does not include in her study). What she does show is how 'Germany has steadily worked towards five (so far) important conventions. Each gives powers to ethnic minorities and regions within countries and takes power away from

nation states. What will that imply for the future relationship between our own ethnic communities and the state? I will only mention two of the five conventions (or charters) so far tabled. The second, known as The Madrid Convention, 'enables regions to have their own independent foreign policy, separate from the countries of which they form a part' (p. 182). The UK is not yet a signatory. The third convention 'allows all regions to be self-governing, obviously to the detriment of the nation state'. Successive French governments have hesitated to adopt this charter but in January 2004 the French government announced it had begun the ratification process. This will divide France in a way that has not existed for about a thousand years (p. 184). John Major's government refused to sign the charter; however, Mr Blair signed it and in 1998 ratified it (pp. 184–5).

The frontier regions mentioned above and in 1998 have developed apace. Borders have been declared the 'scars of history' and so, according to EUREGIO, 'border and cross-border regions are therefore components and brid[g]es in the European unification process' (p. 149). One can see the emotional origins of this position – think Sudeten; think Danzig. Border regions are being extended elsewhere as 'Working Communities' of which there are thirteen, some taking in areas not in the EU, e.g., Euregio Baltyk, started in 1998, which encompasses parts of Poland, Latvia, Lithuania, Sweden, Denmark, and Russia (p. 150). Of course, since 1998 some of these countries have joined the EU. There has been one failure: Arc Atlantic. This attempted to combine regions bordering the Atlantic from the UK, Spain, France, Portugal and Ireland. However, it collapsed in 2004. Ms Jenkins suggests 'It was just too ambitious' (p. 151). I am inclined to think it failed because it was lacking in ambition: it omitted Greenland, Canada, the USA, and South America.

A final example on a smaller scale (except to those affected) showing how Brussels has wrested the control of roads, housing and land development from the UK is telling. The ESDP – the European Spacial Development Perspective (have you heard of it? Do you know what it means?) – has passed the principles for use of our land to Brussels. In February 2004 the East of England Regional Assembly – which is *unelected* – approved a plan to build nearly half a million new homes in its region. In Norfolk alone, 72,400 houses will be built. The *elected* Norfolk County Council no longer has any say in this but wanted the government to fund roads and services for the new communities, particularly creating a dual carriageway on the congested A11 and improving the A47. However, the *unelected* Regional Assembly rejected this. To qualify as a dual carriageway the A11

would have had to be designated a Trans-European link between major centres of population (p. 81). Enjoy that thought when stuck in a traffic jam on the A11.

Are we too sensitive as to what we fear the EU is doing to Britain, not only in regionalisation, but in the whole thrust of its intent? Is it as malevolent as I, for one, fear? Is it to end war in Europe or, beneath all its seemingly good intentions, a continuation by more subtle means of the wars pursued by Philip II of Spain, Napoleon, Kaiser Wilhelm II, and Hitler (not to mention the Danes and Vikings) to destroy or take over the UK and England in particular? If one is tempted to think this, is one being perverse or even wicked? Am I, for opposing regionalisation, 'a Nazi', as a Bishop, no less, has called those who oppose regional assemblies?

One of the puzzles of modern life is how many people with demanding and important jobs are able to devote so much time to involvement in committees that are not their direct responsibility. Orwell so loathed committee work that he used the number of the room where the BBC Eastern Services Committee meetings were held – Room 101 – to describe his private hell and as such it featured in *Nineteen Eighty-Four*. I noticed in Dan Lewis's excellent *Guide to British Quangos* how many professors seemed to find time to chair quangos and certain academics seem forever to be popping up on broadcast chat-shows. Regionalisation in England features what is to me, a communicant of the Church of England, an even more disturbing characteristic. As Ms Jenkins shows, Bishops of the Church of England have involved themselves in chairing Constitutional Conventions – the Bishops of Durham, Liverpool, Birmingham, St Albans, and Exeter. The recently retired Archbishop of York acted as President of the Campaign for Yorkshire. Are these intended to give a patina of respectability to these Conventions? Two regions have not had Constitutional Conventions: London and the South East. Was that, Ms Jenkins asks, because the Archbishop of Canterbury (John Carey) and the Bishop of London (Richard Chartres) were unwilling to head them? (p. 59). As a little boy I recall seeing a fearsome picture of Bishop Odo laying about him with a mace in battle (because use of a sword would lead to bloodshed, which even at the age of about seven I thought a spurious excuse for clubbing a peasant with a studded mace), but I fondly imagined that our Bishops had enough to do to sort out the mess that is the Church of England rather than getting involved in dubiously legal political set-ups. It was the Bishop of Exeter, Michael Langrish, who, in October 2002, when asked by members of his congregation why he continued to chair the South West

Constitutional Convention although so many of them opposed assemblies, retorted 'They are Nazis' – and he then reiterated that, so it was no slip of the tongue. Nothing indicates more clearly the sewer into which the EU's political machinations has dragged decent people than that exchange.

Even though the North-East Regional Assembly was voted down by the people when put to the vote, it continues its costly way, now re-organised as a limited company. The irrelevance of the regions imposed by Brussels is well shown by the need to fit in other elements of our society to accord with regional boundaries even though they make for stupid conjunctions. One of the latest government wheezes is to combine police forces (in passing, allowing a very short time for consultation). If any two forces were to be united, those of Northumbria and Cumbria would seem obvious amalgamations. But that, as a correspondent to the *Daily Telegraph* (14.12.05), Ronald Mallabar, pointed out, will not be allowed. Northumbria is in the Brussels imposed North-East Region, Cumbria in the North-West. As Mr Mallabar went on to say, there was no point in voting in a referendum against a regional assembly because, though those in the north east had 'voted resoundingly against' it made no difference: 'we have got a North East Assembly anyway'. This is precisely in line with what has followed the rejection by France and the Netherlands of the EU Constitution. Brussels has simply gone ahead as if the Constitution were ratified and in force. Thus, to select from a long list, the following are going ahead: The European Space Programme; The EU Criminal Code; The European Defence Agency; The Common Asylum Policy; The External Border Agency; The Fundamental Rights Agency; The European External Action Service; The Charter of Fundamental Rights – and there are more. All this enforced by rulers outside our control whose own Court of Auditors has for eleven successive years been unable to sign off the EU's accounts, declaring 'the vast majority of the payment budget was again materially affected by errors of legality and regularity'. As John Laughland, formerly lecturer at the Sorbonne and the Institute of Political Science, Paris, currently at the University of Marne-la-Vallée, wrote: 'There are simply too many snouts in the trough and too many legs under the table for anything to change' (*DT*, 3.12.05). What voters vote for is increasingly disregarded and the overall effect, from Brussels to the House of Commons, to Regional Assemblies will be for Britain to disappear, as Lindsay Jenkins admirably and alarmingly demonstrates. I would say that this is a book we shall ignore at our peril, except that if we do take note and vote against what is proposed we shall be ignored – except by some Bishop who will describe us as Nazis.

Since I drafted this review, publicity has been given to a Spatial Map of Europe. This was reproduced in colour in, among other journals, *The Daily Telegraph* (3 September 2006). In red is shown that TransManche region to which I referred at the beginning of this review. It comprises Kent and Sussex and North-Eastern France. It was reported on the radio that its 'capital' would be Lille. In the light of Lindsay Jenkins's chapter 19, 'How Far is Germany Implicated' (to which I have already referred), the *Telegraph* reports that when Germany takes over the EU presidency in 2007, it will endeavour 'to dismantle nation states by strengthening and enhancing the regional templates'. In June, a German minister, Wolfgang Tiefensee, said 'There is the great hope underlying the goal of a United Europe that we can permanently overcome old borders'. The defence (by a Liberal Democrat MEP, Andrew Duff) is that this is no more than 'to achieve a norm of statistics across Europe to develop social policy, transport infrastructure and so on. It is just a tool for policy-making.' Perhaps so – or will this be 'the last territorial claim' to be made in Europe?

**P.D.**

## THE HARE & THE TORTOISE: AN INFORMAL GUIDE TO BUSINESS STRATEGY

*By John Kay. Published by The Erasmus Press, 2006, price £8.99 pb*

This reviewer has been teaching university courses on business strategy since 1973. My course at the University of British Columbia was grandly titled 'Policy Analysis and Strategic Management Decision Making', at least for the undergraduates. After teaching 'advanced' versions of this to MBA students both in Vancouver and at the University of Washington in Seattle I returned to London and have taught what is now called 'Strategic Management' at the London Metroplitan University (then known as 'City Poly') ever since.

In the 1970s there was no really useable textbook. We had to develop our own ideas. But one thing was clear; conventional economic teaching condemning 'monopoly' might be useful for public policy makers, but it sent out negative or just plain wrong signals for the businessman whose

very survival depends on the discovery and development of monopolistic elements. Although the 'Austrian' school of economics and in particular the writings of Freidrich Hayek showed an awareness of the problem, this was not the mainstream. The field was open.

Now, more than thirty years later, library shelves groan under the weight of thick, hyped, mainly American, volumes analysing strategies, strategy implementation, case histories, probabilistic strategic methodologies and (often insultingly obvious) diagrams and 'paradigms'. Students with the spark to become entrepreneurs are much more likely to be discouraged than enlightened by so much pseudo-intellectual baggage. I now know where (some of) the gems are to be found – which authors, articles and tools of analysis can be worth studying. But if I was starting again it would be like driving a miniature bulldozer into a giant blancmange!

Enter, John Kay. 'The Hare & The Tortoise' is a book of short pithy chapters that distils what we have learned about business strategy, shows the application of the principles to admirably condensed case studies, and leaves the reader feeling informed and confident – and importantly, with convincing insight that can be put to practical use. I shall have no hesitation in telling students, for my course in October, to read this book for pleasure before the course begins and then again, for a summary and revision at the end. I have read other books by John Kay. They are entertaining and of substance, but it is 'The Hare and The Tortoise' which contains chapters which will linger on reading lists for the longest time.

At the core of Kay's presentation there lies the comparison of 'distinctive' and 'reproducible' capabilities of a firm. A firm with only 'reproducible' capabilities cannot, in anything but the short term, make anything beyond very ordinary profits. It is the 'distinctive' capabilities that allow it 'competitive advantages' and thus the profits to prosper and expand. Such capabilities may be found in patents and secret processes, but are more likely to be found in brand name strength, organisational continuity and webs of relationships built up over many years. These concepts lie at the heart of corporate valuation and it has always been a mistake to analyse them simply as something 'monopolistic'.

There is much more – of course, for this book is informative and entertaining as well as being the presentation of an analytical structure. It is certainly a purchase worth making.

**J.B.**

# LETTER

*Some Challenging Thoughts on Governance and Democracy in 2006 UK*
*from Brian Lewis*

Sir,

I have been trying to understand recently why it is that the British government itself and its support units from the Civil Service seem to be breaking down. What could be the underlying reasons?

There are a number of puzzles. Going to war seems to have been a personal decision of the Prime Minister himself, in consultation with a foreign power, using Royal Prerogative without the consent of parliament and based on singularly little personal experience of Middle East politics and society. I am all for good pragmatic decisions that are successful, but this is absurd and should not be left in the hands of one man.

The National Health Service, instead of getting better, is getting worse the more money is thrown at the problem. The politician in charge actually said 2006 was the best year for the NHS so far, a direct contradiction in terms to what most of us have been thinking. Computer systems ordered at huge cost do not work. Is the Prime Minister himself making these complex technical decisions? It may be so!

The police have shot down suspects and then apologised afterwards for making mistakes. One can understand occasional mistakes in moments of extreme violence, but statistically only innocent people so far have been killed. That is pretty close to a breakdown of discipline within government itself.

In the Home Office, officials deny having any idea how many illegal immigrants there might be and seem helpless in deporting them when they do know. Criminals are set free and then government has no idea where they are. The government itself seems constrained by (EU) laws over which it has no control and must follow blindly.

The Prime Minister seems bewildered by all this as if he took over command of government only a few weeks ago when in fact it has been nine years! The Prime Minister's views seem to be that democracy is outmoded and he needs draconian laws, which interfere directly with the idea of freedom. It is strange that a trained lawyer should be so cavalier with our ancient rights and freedoms.

I ask myself why should this be so. What can be causing this incipient incompetence? Something is going wrong. What could it be?

My only explanation is that a significant proportion of any nation is increasingly becoming self-sufficient educationally, socially and financially, without a direct need to participate in governance. The government is in effect representing the other 50%, who are not university graduates – and is largely staffed by such people!

This might have been forecast by observing the increasing number of educated people in society and by looking at the globalisation of the world, in which so many of us sadly are no longer directly linked with our home countries – because governments do not want us to be!

Indeed, the situation is aggravated by governments deliberately refusing to include their overseas citizens in any concept of democracy and refusing them the right to vote. The British government no longer acts on behalf of its *nationals*, but on behalf of residents in the UK. I can see that a grand Utopian idea, where we are all equal and must be treated so, might be the way forward, but I would like to see the government arguing the case rather than keeping the new policy secret from the voters.

So my explanation for what is happening is that governments are becoming an irrelevance to a large proportion of their populations, who look after themselves. The government is left with a social rump, which elects them and which it employs. Ministers have no international experience and as the saying goes could not manage a 'winkle stall'. Many years ago that was said in jest, but sadly seems now to be true. Quite what is happening in the Civil Service is unclear. It could be just that government leadership is lacking, but one cannot help wonder whether the Civil Service itself is out of touch and unable to react to real events.

We, the other 50% of the nation are strangely unable to help. My great-great Grandfather was a superintendent of police and I might have been a union leader. Today that would be impossible. As I often say, the Welsh ploughboy which once I might have been 150 years ago, no longer entirely belongs to his own society. What I fear has happened is that so many of us who have become educated, who have travelled the globe, and who have become economically independent are no longer thought by government to have any role to play at home or abroad, just as our experience is most needed.

If 50% of a nation no longer plays any role in governance, that would go a long way to explaining why government, unable to access the right experience now available, is becoming incompetent and increasingly lost in a world where good fundamental cultural and technical understanding of the issues is essential.

Who would have thought that the long march from Magna Carta to today would eventually arrive at a situation where Parliament itself has reached its ‘sell-by’ date and has to be replaced!

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Parañaque MM
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## NEW MEMBERS

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iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.
iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.
v) To publish reports and other documents embodying the results of study and research.
vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.
vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.

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

SIGNATURE OF PROPOSER..........................................................................