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AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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‘MINORITY REPORTS’ ON THE UK ECONOMIC OUTLOOK

By Peter Warburton

The dangers of judging economic performance through the narrow prism of Gross Domestic Product statistics were pointed out long ago by John Kenneth Galbraith in *The Affluent Society* (1958) and Ezra J Mishan in *The Costs of Economic Growth* (1967). While their critiques of economic growth and development were determinedly anti-materialist and anti-capitalist, they nonetheless correctly identified the flaws and limitations of GDP as a measure of progress. GDP stresses the quantitative over the qualitative; it is indifferent to all distributions of income, whatever inequities and injustices they imply. GDP cares not whether its derivation is sustainable or not, nor whether its expenditure and output components are internally well-balanced. In short, GDP will only be a well-respected measure of economic progress when it is recursive to soundly-based economic activity and keeps a low profile. As soon as GDP growth became a policy target, its usefulness as an indicator was compromised.

Under Gordon Brown’s Chancellorship, GDP has achieved iconic status. It is the blunt club used to bludgeon critics of his economic policies into submission. His claims regarding the longevity of the current UK economic expansion and the reduced variability of the pace of economic growth are repeated at every opportunity. Mr Brown regards the smooth progression of GDP as proof that the expansion is both authentic and sustainable. In this article, I examine various evidence and arguments to the contrary.

Central to my case are four underlying paradoxes. First, how can it be that the economy is growing at or above its long-term trend rate when so many households are in financial distress, are state-dependent or both? Second, how can visible exports grow so rapidly when the output of goods is virtually stagnant? Third, how can net trade detract so little from economic growth when the deterioration in the net international investment position is so great? Fourth, why are the public finances in such a poor state if the economy is recording trend growth or better?

A. The paradox of household finances

National accounts for the third quarter of 2006, released in December, confirm that the household sector is struggling. The latest labour market release shows an increase in unemployment on the ILO measure of almost 200,000 in the year to October and virtually no gain in total hours worked in the economy on an annual comparison. This is reflected in a weak showing for wage and salary incomes, up by 4.6% in the year to Q3. Households' gross disposable income growth slowed from 5.1% in 2005 to 3.7% on the latest comparison, with real disposable income growth at 1.3%, but only 0.4% higher in 2006 Q3 than 2005 Q4. The saving ratio fell from 6.2% in the final quarter of 2005 to 5.1% in 2006 Q3.

Chart 1 reveals that real after-tax incomes of the household sector have seldom kept pace with real GDP since 2002 and are decelerating once more as corporate profits absorb a higher percentage of national income and as the tax and national insurance burden grows faster than household incomes.

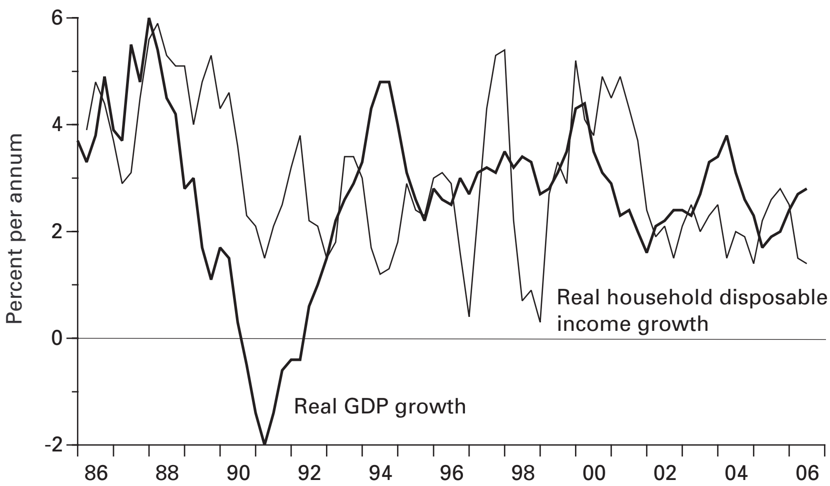

Chart 1: Divergence of household real income from GDP

In an economy experiencing consistent annual growth of around 2.5%, it is unusual and disturbing to find steady increases in the numbers wholly or partially dependent on state benefits and tax credits. Since July 2003, the numbers of Working Tax Credit claimants has risen from 1.59m to 1.92m. For the over-60s, the numbers claiming means-tested benefits have increased from 1.74m in 2002–03 to an estimated 2.7m in 2005–06. Public expenditure on social protection has increased from £141.8bn in 2000–01 to

£166.8bn in 2005–06, expressed at 2004–05 prices. Meanwhile, public sector employment has increased substantially in recent years, with payroll costs increasing from £93.1bn in 2000–01 to £130.2bn in 2004–05, indicative of an employment gain of about 16% over the 4 years.

An even more alarming contradiction in household financial health lies in the exponential growth in debt delinquency over the past five years. The number of personal insolvencies in England and Wales has risen from 7,280 in 2002 Q1 to 27,644 in 2006 Q3, with a 55% increase in the year to the third quarter of 2006. At current rates, 1 in 400 adults enters insolvency each year – either outright bankruptcy or an individual voluntary arrangement (IVA). If this trend continues, the incidence of insolvency will be 1 in 240 a year from now, and 1 in 145 in two years' time. By then, most economists and financial commentators would concede that personal indebtedness was a macroeconomic as well as a 'social' problem.

In addition to the visible delinquencies, there is a much greater problem of latent financial distress. Survey evidence suggests that up to 2 million households are considering bankruptcy as a solution to their current financial difficulties. There is ample scope for the annual volume of IVAs to more than double from current levels, perhaps reaching 100,000 in 2008. Total bank write-offs of sterling loans to the household sector climbed 34% for the first 3 quarters of 2006 over a year earlier. Thus far, there has been almost no mention of mortgage loan delinquency, despite the burgeoning sub-prime and buy-to-let markets. Numbers of buy-to-let advances rose from 93,400 to 152,500 between the first halves of 2005 and 2006. These are obvious contexts in which to expect delinquency problems, given the high degree of leverage involved.

Current incidences of debt problems are unprecedented in a growing economy. If real household incomes continue to stagnate, delinquencies could explode, with direct and immediate effects on personal consumption and employment.

B. The paradox of export divergence

It is not unprecedented for the growth of visible export volumes to outstrip the growth of domestic goods output by a wide margin – Chart 2 shows that this has occurred various times before. However, it is remarkable that such a strong export performance should be achieved when manufacturing sector output has been declining, or at best stagnating, and in the context of a very buoyant currency. The size of the Missing Trader Intra-Community

(MTIC) VAT fraud and the difficulty in excising its influences from the statistics add to the skepticism over the official portrayal of visible export growth in 2005 and 2006. If, indeed, the size of the fraud has been underestimated, then this would help to reconcile the paradox. Either way, it seems likely that visible export growth will contribute rather less to UK economic growth in the coming year.

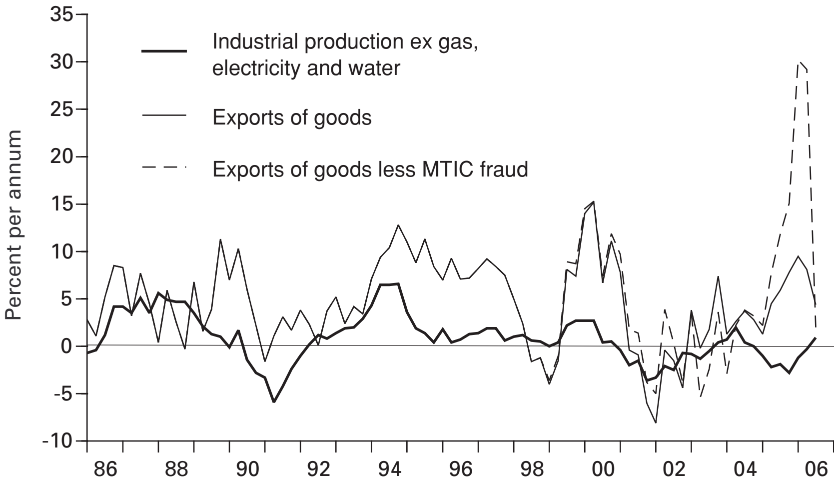

Chart 2: Divergence of export and output growth for goods

C. The paradox of the international investment position

In times past, above-trend economic growth was associated with a net accumulation of international assets. No more. The UK's net international investment position has fallen by 17% of GDP in the past three years and is spiralling downwards. Just as, in the 1970s, conglomerates such as Hanson and BTR pioneered steady earnings progression using financial engineering techniques, the age of innocence has passed also for the national accounts. The increasing complexity of financial instruments has offered governments attractive alternatives to politically painful economic decisions, such as public expenditure cuts. The discounted present value of Private Finance Initiative/Public Private Partnership projects has risen from £40bn in 1997 to about £100bn today. The value of unfunded public sector pensions has ballooned from £320bn in 1997 to at least £500bn today – much more on updated assumptions of longevity.

Further evidence of deterioration in the true public sector balance sheet, as opposed to the official one, is contained in the international accounts. The 2006 Pink Book reveals that the central government contribution to the net international investment position slipped from minus £29bn at end-2002 to minus £86bn at end-2005. But the most glaring deficiencies in the external balance sheet position are attributed to companies and non-bank financial institutions. Astonishingly, for an economy with an average annual real growth rate of 2.67% since the first quarter of 2003, the overall net investment position has fallen from a surplus of £3.4bn to a deficit of £237.5bn.

The largest component of decline is net direct investment. Total direct investment abroad is little higher now than three years ago while direct investment in the UK has risen by about 50%. Typically, this inward investment represents the sale of existing business units to foreigners rather than income-generating new-build. The next largest contributor to the overall decline is net banking flows. While the statistics do not allow us to identify the split between non-financial and financial companies, it

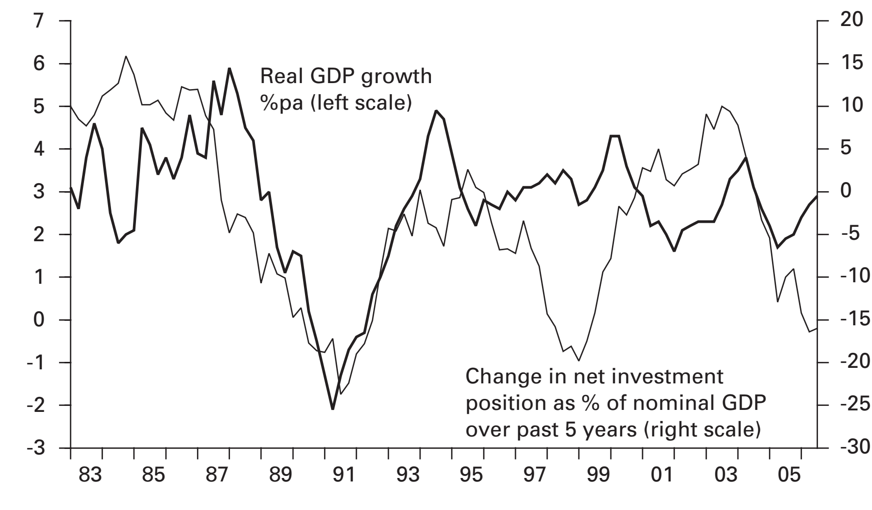

Chart 3: Real GDP growth vs. change in net international investment

is likely that the deficit is attributable primarily to securities dealers and investment banks.

The sharp fall in the external balance sheet in 1997–99 was rectified by the equity market crash of 2000–02. The problem today is that foreigners have acquired UK businesses and bonds rather than UK equities. All of which places the authenticity of UK GDP performance in great doubt.

D. The paradox of the public finances

Britain's new-found economic stability, allegedly the longest running expansion since records began, is a strange beast. On closer examination, it seems that only the data are stable; unemployment is rising steadily and the public finances have earned successive rebukes from the EU and the IMF. Not only has private sector employment stagnated over the past 4 years, but the public finances have worsened. UK economic growth and total employment have been shored up by progressively larger injections of public funds. Public sector net borrowing rose from a small negative in 2001–02 to £24.9bn in 2002–03, £34.1bn in 2003–04, £39.1bn in 2004–05 and £36.9bn last year (mitigated by unexpectedly large oil and gas revenues).

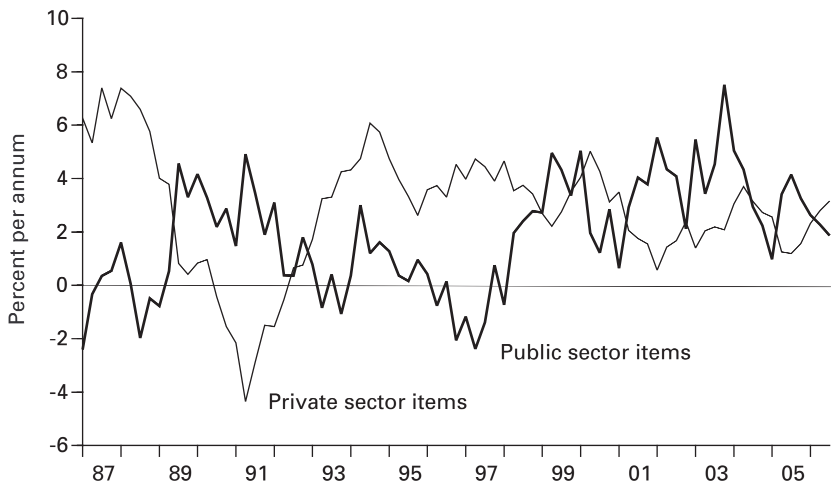

Chart 4: Private and public sector components of the growth of GDP at basic prices

After 8 months of the 2006–07 fiscal year, the cumulative shortfall is almost £32bn, and heading for an outturn of £40bn.

Now that unemployment-related and other social security benefits have positive momentum, a further overshoot can be expected. As the pace of consumers' expenditure decelerates, so VAT receipts have weakened to a 4% annual pace.

Far from the headline increases in City bonuses, the mainstream economy is struggling under a squeeze in real disposable incomes, increased debt service charges and energy costs. The longer this experiment in stability continues, the more unstable it becomes.

An attempted explanation

A common thread running through the more successful sectors of the UK economy in recent years, measured by output growth, is their affinity with capital market finance and transactions in property, business and financial assets. Increasingly, private economic growth is led by the deal-driven, capital market-financed sectors. The characterization of economic growth is being skewed away from the efficient transformation of labour and physical capital inputs into marketable outputs, towards the frenzied turnover of assets. As London has gained global market share in financial transactions, the contribution of the deal-driven infrastructure to economic growth has increased steadily and has distributed income and capital in a more concentrated fashion.

The failure of real gains to trickle down the income scale has been mitigated by a revolution in credit access to the unwaged and to those with chequered employment and credit histories. They have become the unwitting fuel for a sub-prime personal lending boom. It has been further mitigated by a sizeable distribution of public money as in-work benefits, alias tax credits, by a strident expansion of public sector activities and the public funding of employment within the public and private sectors. The public sector's contribution to economic growth has compensated for the progressive weakness of the private sector. It should be obvious that this requires public sector revenues and expenditures to absorb an increasing share of GDP. To the extent that the public sector is unable to command sufficient tax revenues, it must resort to primary borrowing in order to provide an offsetting stimulus.

At the heart of many of these incongruities is the emergence of a few hot sectors or activities that confer disproportionate gains on a small percentage of the workforce. The concentration of income growth among those with high marginal tax rates is helpful to the gathering of tax revenue. This enables the public sector to fund an expansion of its activities and to provide additional employment. Slackness of lending standards and greater risk-taking behaviour by the financial sector has bridged the gap between inadequate after-tax incomes and rising consumption. Thus, the explosion of insolvency is likely to be sustained over many years.

The UK economy is extremely vulnerable to a financial sector setback that combines with tighter credit conditions. Not only would the growth contribution from the hot sectors fail, but tax revenues would be severely disrupted. A failure to appreciate the outsized contribution of heightened asset turnover to corporate profits and to GDP has allowed the government to portray UK economic performance and prospects in a false light. The scope for disappointment is significant.

THE BRITISH AND AMERICAN ECONOMIES

A talk given by Mr Irwin Stelzer, financial columnist of the Sunday Times, to members of the Economic Research Council on Monday, 30th October 2006

Many thanks for your invitation to exchange a few ideas with you. I propose to open with a few remarks about the state of the US and UK economies, and then spend a few minutes on each of two topics which are of current interest – global warming, which seems suddenly to have captured people's imaginations, and the implications of the American mid-term elections for you here in the UK. Interest in the latter. I believe, stems in Britain from a lack of complete satisfaction with the current administration!

The American economy is slowing down. The third quarter GDP figures, which came out late last week (keep in mind that these are very rough and substantially revised) show a growth rate of 1.6%, which is low. [Note: since this talk, the figure has been revised to 2.2%, and may be revised again.] It is widely believed that our economy can expand at somewhere between 2.5% and 3.0% without triggering inflation, so we are experiencing below trend growth. A caveat: to call current growth 'below trend' only proves that economists use decimal places because they have a sense of humour.

We cannot measure GDP, or almost anything other economic variable, with that precision. Nevertheless, the Fed is counting on slower growth to reduce inflation to its preferred range of 1% to 2%, or at least the range it says is preferred – there is considerable debate about that as well.

I suspect that Mr Bernanke is attaching a lot less weight to aggregate growth figures than to the details: inventories grew rather sharply. In a period of rising economic growth inventories grow because people expect they are going to sell more, and so stock up the shelves – a good sign. On the other hand, when growth is slowing and inventories rise, it is because manufacturers can't sell what they produce, so rising inventories are a sign that economic activity in the future will slow. I suspect that that is what Mr Bernanke is counting on to keep the economy cooler than it would be if we continued to grow at the 5.6% rate reached in the first quarter, a rate that most people think is unsustainable. Another caveat: we are not certain that is so, any more than we are certain that if the government claws more than 40% of the economy bad things will happen. Gordon Brown has bigger claws than that and nothing bad has happened. We use these rules of thumb and when they are proved wrong we say, well we meant in the long run. There is a saying in my business – give them a number and give them a date, but never give them a number with a date!

My own view is that growth will accelerate in the final quarter, in part because petrol prices have come down so much. Analysts at Goldman Sachs have found there is a very close short-term relationship between petrol prices and household spending growth. When petrol prices go down, household spending growth goes up, and the drop in petrol prices since June has probably added about 1% on an annualised basis to consumer spending, which is about $90 billion a year, and that is not a little bit of money. If I am right, that means that we will probably have a stronger economy than a lot of people are saying, which will make inflation a lot more difficult to tackle, a bit more stubborn. That view is based in part on the fact that I see little reason to believe that the rate of price increase in the service sector, which is 70% of the US economy, is likely to decline in this period of rising wages. Even if we have softness in the manufacturing sector, I don't see any reason to think that we are going to have a quick easing of inflation to the 1–2% range.

I am a little more optimistic than most people for the fourth quarter into 2007 for still another reason. Incomes are rising rapidly in my country. Personal incomes in September were 6.8% above a year ago. That is big-time increase. The White House estimates, and there was a sort of full-court press last week (if I might use a basketball term) by the White House, mentioned in my column, to shift the focus from Iraq to 'the economy stupid' (Bill Clinton's famous conclusion about what drives elections). The White House has a favourite number – the average income in America per family is $37,000 a year. The increase in income this year comes to about $800 for that family, which is about what that family spends at Christmas. Therefore we are going to have a nice, free merry Christmas!

The trick for a politician is to make economic data understandable. Most people don't understand and can't relate to $2 trillion, but they do understand $800.

I happen to think the administration's economists are right: there is a lot more zip still in the consumer economy. The retailers I talked to are expecting growth during the Christmas season to be around 5% in the face of falling prices for a lot of consumer goods. The price of flatscreen television sets is down about 30% from last year so to get your total sales figures up 5% you are going to have to move a lot of flatscreens and an awful lot of merchandise, which I think they will, which of course bodes well for China.

Everything really hangs on the housing market, and the effect it proves to have on the overall economy. In this country when an American economist is invited to a dinner party the conversation generally falls into two parts – what do you think is going to happen to the value of my house? And how stupid is your President? If the second question comes before the first, it is my practice to depart, and leave the dinner party hanging as to what is going to happen to the price of their house. But not before suggesting to them that they look at the President's summer reading list!

Back to the housing market. We know some things, but not the most important thing. We know that the direct effect of a slow-down will be lay-offs in the construction industry, lay-offs (I don't know if this is a net social good or not) among property agents, among mortgage lenders and so on. We know that sales of new and existing properties have slowed down. We know that prices have come off the boil. But we don't know what this means for consumer spending. Some analysts say there will be a sharp drop because consumers won't (to use jargon) de-equitise their houses any more, that is treat them like ATM machines. That process is simple: every time the equity value of your home goes up, you borrow more on it, and then spend it. It is not clear how much of that has happened and it is not clear how much of the spending represented investments in improving the house, which improves the equity value. They also are guessing that consumers will feel less rich if the price of their homes fall, and will retrench. But I am not certain that is entirely right. You have to keep three things in mind when thinking about the housing market.

First, as Alan Greenspan puts it, there are what he calls early signs of stabilisation in the American housing market, perhaps because mortgage interest rates are falling. Second, we have the experience of Australia, where a softening did not lead to a recession. Third, homes are not like shares. If you don't like the price you are offered for your house, you just stay there, you don't sell. Your balance sheet might not look as good, but I don't know how many people examine their balance sheet every morning before they make a trip to the mall. I am just not sure. Besides, on the asset side, Americans who own shares have been doing quite well in the stock market, off-setting some of the effect of the drop in house prices on consumer balance sheets.

Besides, economists are helped when we have actual historic data to look at, and we have no data that reflect anything like this kind of housing market that we have had in America, so we can't separate out the speculative boom that we know has occurred in Florida and Las Vegas, where people buy 4 or 5 condominiums with the hope of flipping them very soon, from the underlying demographics. The latter suggest that we are blessed with a large wave of immigrants who are first-time home buyers.

Let me summarise the pluses and minuses, so that you can draw your own conclusions about the state of the US economy. House prices are falling – that's a negative. So are petrol prices – that's a positive. Share prices are rising – that's a positive. Consumers' incomes are rising – that's another positive. Unemployment is low at 4.6% and in the year ending in March, America created 2.8 million jobs – that's a lot of jobs. Corporate profits are exceeding expectations – that's another positive. Inflation is running at an annual rate of 2.3%, which is above the comfort zone that the Fed has set, which would suggest that it will keep tightening money or at least keep money as tight as it is. On the other hand it is down from 2.6% in the previous quarter and the Fed thinks that what we are seeing now is the inflation rate that was 'baked in', as they put it, several quarters ago by high petrol prices and that this will automatically come down, even if the Fed does nothing.

Now, how you pull all that together depends on your own judgment of the relative importance of these factors and a host of others, including what you think is going to happen to the dollar. I taught economics for a while and I would have confidently been teaching in the classroom that the dollar would have been 'tanking' by now because of sustained trade deficits. It is not. It's not great but it's certainly not collapsing as a sustained trade deficit of 6+% GDP might suggest it should That's because when we speak about the future of any economic variable we economists say, 'Other things being equal, this will happen'. When you get out in the big world other things are not equal. So my habit, when asked about the future of the dollar at cocktail parties, is to say the dollar will rise unless it falls or remains stable. Economic forecasters were invented to make weather forecasters look good! I try to avoid forecasting. We have a practice at The Sunday Times: write on any subject you believe is relevant to your reader. But the year-end column is supposed to be a summary of the old year, and the first column in the new year is supposed to be a forecast. I generally avoid this peek into the future, except in very general terms. This causes my editor a bit of consternation, since he knows what readers want – they want a forecast and believe economists should be able to provide one. My hunch, not a forecast, is that we are heading for a soft landing in America with growth in the 2%–3% range. I think that will be fine. It won't feel good because after 5.6%, 2.5%–3% doesn't feel terrific, but it's about what the economy can sustain given the long-term commitments to the baby boomers, given trends in productivity and everything else. Such growth is certainly not a recession.

Now, speaking of weather forecasters (I am trying to find a way to segue into global warming and that's the closest I could come), let me say a few words about the media frenzy that seems to be following on the heels of the Stern Report and Al Gore's foray into the movie business. Have any of you seen that movie? Well, I was privileged to see the slide show version by Al Gore. The advantage of a slide show to the audience is that it is dark and you can sneak out.

It is possible that the earth is warming. It is only possible, it is not certain that the earth is warming, and it is possible that human activity – our cars, our factories, our TVs and our fridges – are all contributing to that problem. That is also possible, but not certain. But you are not certain you are going to be burgled and you still buy insurance. So the possibility that the earth is warming, which some scientists say is the case and some say is not, and the possibility that it is human activity that is driving this warming, which some scientists say is the case and some say is not, is sufficient to make us want to buy reasonably priced insurance, especially since that insurance at the same time will reduce our dependence on oil from countries supporting terrorism. The arguments about whether the earth is warming or not warming or whether we are causing it should be over. They don't matter. The question is, has a case for buying insurance been made that is strong enough to warrant paying a reasonable premium for that insurance? I think the answer to that is yes. That means that we need green taxes, but that is not a green light for the government to dip its fingers even more deeply into our wallets and purses. Britain is already one of the most highly taxed countries in Europe and is heading up while others are heading down. If the government cannot get by with 43% of GDP you should get another government – although the possible other government says it is going to increase spending on public services; so I don't really know what you should do. You have a choice of three – bad, worse and worser – and that's a problem! But David Milliband, the Environment Secretary, has some very sensible things to say about taxes.

A warning about environmental taxes. Take the dreaded SUVs which some people seem in this country to consider environmentally undesirable vehicles. If you so hold that view, don't tax SUVs, tax the use of the SUVs. My wife and I each have an SUV in Colorado, where it happens to snow a lot and where we live on a hill. We each drive perhaps 2000 miles a year because we are rarely there. People with smaller cars who live there full time drive perhaps 10,000 miles per year, and therefore contribute more to global warming than we do. So you want to tax use of SUVs, not the ownership of them. So do be careful when you formulate specific green taxes. In addition, consider creating a real market for carbon permits, which would go a long way towards sorting out a lot of these problems for you. So far, so good.

The trouble is, I have been proposing green taxes for about twenty years, always adding a sentence some people seem to forget: 'lower other taxes'. In Britain the government already takes 43% of GDP, and is talking about raising taxes still more. It is constantly scrounging for higher taxes, but in my view if you are to have green taxes, you should then lower taxes on things you want to have more of. You put in the green taxes because you want less of something. What do you want more of? You want more jobs. Well you should lower NICs. It seems to be that you want to attract small businesses, well then you should lower tax on small business. In short, raise taxes on 'bads', and lower them on 'goods'.

I was addressing a group of small businessmen the other day and the gentleman who started Yo-Sushi proposed that taxes on the first tranche of profits in a small business should be zero, and that small businesses should be exempt from regulation. 'Just leave me alone.' I started a business here and a business in Washington at the same time. In Washington I found an office, I signed a lease, painted my name on the door and I was in business. Here I found an office, I hired a solicitor, I hired a VAT consultant, filled out a bunch of forms, and a couple of months later I was in business. Use the proceeds of green taxes to make it possible to waive all of that for small businesses.

Now here is the response to that idea from those who would use green taxes as an excuse to increase the total tax burden. They argue that the green taxes are designed to change behaviour. They are not designed to raise revenue. It is like saying, 'I am going to put a huge tariff on Chinese goods to keep them out and what do I do with the money?' Well, if you keep them out you won't have any money, and if green taxes change behaviour you won't have any revenues from the green taxes because nobody will drive those cars or buy any fridges and so on. The trouble with that argument against making offsetting reductions in other taxes is that it takes a long while to change behaviour. Not because people are stubborn, but because we are dealing with capital goods. The average car in America lasts for 15 years, before it takes on a new life in Latin America, for example. So it is going to take 15 years to turn over the stock of automobiles, during which time the green taxes will have been generating revenue. The trick is to find taxes you can cut that allow the economy to grow so that, as the green taxes phase out, the bigger economy produces more revenue to make up the difference. I think that's a perfectly sensible thing to strive for and in the long run will be the right thing to do. So raise green taxes, lower taxes that stifle economic growth and you might have a policy that works economically for Britain.

Finally, let me say a word about the up-coming American elections. Let me focus on Britain's interest. Let me start with the proposition that, whether you love Tony Blair or you hate Tony Blair, he is right about one thing. He has always said the world has more to fear from an American retreat from engagement with the world than from American over-reach. The Prime Minister gave a speech in Chicago in 1999 when George Bush was still Governor of Texas. Blair pleaded with the Chicago audience never again to fall for the doctrine of isolationism; the world cannot afford it. Stay a country outward-looking, with a vision and imagination that is in your nature, he urged us – which is one reason that you have a very big stake in the American elections. There are 435 members of the House of Representatives up for re-election, along with 33, I think, of the 100 Senators, and 36 of the 50 State Governors, who can be important, as you can see from the deal California Governor Schwarzenegger and your Prime Minister made about global warming. The states are ahead of the federal government on this issue.

Now it is probable that the Democrats will regain control of the House, and in their drearier moments the Republicans say that they will lose the Senate as well. That latter loss is probable, but not certain because the Republicans respond (the more cheerful ones) that all of this talk about Iraq and dissatisfaction will be offset because Karl Rove, who is the President's principal political advisor, will turn out the masses of voters on the three Gs – guns, gays and God – and that they will outnumber the Democrats who show up at the polls. Last week when the New Jersey Court ruled that civil unions are entitled to the benefits of marriages, the Republicans used that decision to stir up their core base. The Democrats are trying to live down their image as a secular, metropolitan party – the equivalent of a cheese and Chablis party. Howard Ford, who is a very attractive black candidate running for the Senate in Tennessee has said, 'I won't take your Bible and I won't take your gun if you elect me'. [Note: in the event, Ford lost a close race.] That is part of the Democratic mantra now, to offset the view of many voters that they are a secular, metropolitan party.

If the Democrats fail to win either House, George Will, who is a widely read conservative columnist, has suggested they find another line of work because the time has never been better for them to do that: Iraq is a mess and the voters' approval rating for the President is very low. The Democrats see this as a prelude to 2008, when it is more rather than less likely that John McCain will run against Hilary Clinton. In the meanwhile it will certainly make a difference if the Democrats do control the House because the House is run by very powerful committees and the committees are generally anti-war and anti-Bush. They will control the funding of the war as they did in the Vietnam War. They will launch a series of investigations on the conduct of the war, they will investigate the domestic security measures undertaken by the Bush administration, the awarding of contracts for reconstruction in Iraq, and although they are denying this in public, in private they are talking about setting the stage for impeachment proceedings. The Democrats are very angry, and they want to get even for the Clinton impeachment proceedings.

To think about the effect on Britain of the American election, conjure a world in which the only nation with the power to take on North Korea and Iran is in the grips of political paralysis for two years, always under pressure from Democrats (remember George McGovern's slogan, 'Come home America') who are reviving that isolationist cry. Think about what might happen in the long run if Congress forces a hasty retreat from Iraq and drives America into cowering isolationism. At that point the Prime Minister's nightmare of an unpoliced world will become reality.

Consider, too, a country in which the trade unions regain considerable power. They are not as powerful as they were but still call the tune to which lots of Democrats dance by providing fund-raising and activists on the street. If the Democrats win even one of the two Houses, the possibility of passing any significant new free trade agreements will be zero. They believe globalisation and free trade result in inequities. The Doha Round, on life support at the moment, would certainly be dead. I think that's bad for Britain. I think that's bad for the world but it is something you should think about when you think about who you want to win the elections.

Not all of the news is bad from Britain's point of view. Both political parties here (or all three if you count the LibDems) have decided that global warming is a serious matter, and the Democrats are more in line with that thinking than are the Republicans. So if you worry about global warming, rest assured that young Mr Miliband will get a more friendly reception from committees in Congress run by Democrats than he would from committees run by Republicans.

Finally, the British foreign policy establishment would find the Democratic approach to multination bodies more to its taste. President Bush and most conservative Republicans have never set much store by the UN, which they regard as hostile to US interests. It is a dysfunctional and corrupt organisation in which the Disarmament Committee is chaired by Iran, and the Human Rights Committee is chaired by Libya. No surprise that Republicans don't find it a congenial place. Democrats, on the other hand, are much more like your Foreign Office. They have greater faith in international institutions, in multi-national institutions, than do the Republicans.

All in all, an American election that will importantly affect British interests. If you believe it is important to stay the course in Iraq and keep free trade flowing, root for the Republicans. If you are a UN fan, and agree with Al Gore that a global melt-down is nigh, root for the Democrats. Either way, hope that American does not withdraw into itself, as it has done in the past, with horrendous consequences for world order. [Note: In the event, the Democrats won control of both the House and the Senate.]

ADAM SMITH'S RELEVANCE TODAY

A talk given by Dr Eamonn Butler, Director of the Adam Smith Institute, to members of the Economic Research Council on Thursday 5th October 2006

You are lucky to get me here tonight because I hate leaving Westminster – I like to be close to my money! I should also point out that although my talk takes Adam Smith as its starting point, I don't remember claiming to be a Smith expert. Unlike, I now discover, Gordon Brown, who apparently takes the Theory of Moral Sentiments to the beach as his holiday reading.

Let me tell you that in the last six months Gordon Brown has been attempting to re-brand Adam Smith, the father of modern economics, as some sort of very early Scottish socialist. He has been organising seminars and getting academics to write on Smith pointing out how Smith's Theory of Moral Sentiments is more important than the Wealth of Nations, so that if Smith were alive today he would really be a supporter of the Institute named after George Smith rather than the Institute named after Adam. He even wrote a foreword to a book by Ian McLain, the subtitle of which was 'Adam Smith – radical and egalitarian'. And that says it all.

Smith was indeed a radical, was indeed in a sense an egalitarian, but not, I think, in the way that the Left talk about and quite commonly suppose. And that's the trouble with politicians. Talk is cheap because supply exceeds demand!

When Smith was about three years old he was kidnapped, by gypsies we are told, for ransom and eventually his uncle led a posse into the woods and got him back. The Chancellor it seems to me is trying to arrange a second kidnapping of Adam Smith – not of his body, but of his spirit. It seems to me that this is really completely mistaken because it is impossible to recast an 18th century figure in 21st century terms.

A different world

When we started the Adam Smith Institute in 1977, I tried to include a quote from Adam Smith in every publication that we produced and, up to a point, that was great. There *were* nice little quotations and it worked very well. The only trouble is that Smith had nothing to say about pensions or long-term care or incapacity benefit. He certainly said nothing at all about aviation costings and how to privatise the airports or nuclear power, which makes you realise that the world really was quite different in those days.

People thought differently. Their intellectual background was different. What they knew was different, and you cannot really translate somebody to the 21st century and say he was a rabid capitalist, or that he was an early semi-Socialist. It just can't be done.

Smith was certainly an advocate of social and economic reform, as indeed is the Chancellor, and as indeed am I, but it was a different world. Different sorts of money were circulating in Britain at the time. There were different standards of weights and measures. Craftsmen could not practise outside their own town. If you were a carpenter you were not allowed into another town to practise your trade. It was a crime to lend money at more than a specified rate of interest, and of course (well I suppose this hasn't changed very much) monopolies were granted by the government for the benefit of particular groups that would support them.

But a simple truth – the mutual benefits of trade – remains

But Smith's insight, which does translate to this century, was the theory that a free economy, stripped of its restrictions benefited the poor as well as the privileged. It was the view in the 18th century that all trade benefited the rich – that's why they did it – and that the sellers were the ones who benefited. But Smith's great insight was to see that in a free transaction both sides benefit. People wouldn't enter into a free transaction if they didn't benefit – why should they bother? And so it seems to me that the Left forget this, they still think of trade as something which benefits the privileged classes, benefits the rich. They don't really see the benefit to ordinary people in trade. They are suspicious of trade just as people were in the 18th century. Smith recognised the dynamic effect of all of this, that when you do allow people to trade freely, you get choice, you get innovation, you get improvements because of competition, and again I think the Left too commonly forget this. They assume that you can regulate trade, you can tax trade, and that somehow you can carry on as normal, but in fact that is not the case and you lose this dynamic. I think that is where the misunderstanding lies.

Three false arguments

There are three main arguments which Gordon Brown and his colleagues have made to show why they think Smith is really the proverbial Scottish socialist rather than the rabid promoter of the free market which I think

Smith is. The first is this idea that Smith was actually very critical of business people, and many people quote the passage where he says that business people from the same trade seldom meet together, even in merriment and diversion, but the conversation turns to conspiracy against the public. So anyone can write that he is very concerned about cartels and price fixing. Everybody can quote that.

Nobody looks at the next paragraph, which asks what makes these cartel meetings necessary? Smith says that a regulation which says that you actually have to raise money from people of the same trade in order to set up a committee or a policing agency and demands that people of the same trade should be registered makes these meetings much easier because then everybody can look up who the other persons in the trade are and they can all get together. That makes these meetings not just more likely but actually necessary. Think of self-regulation – you have to come together to pursue this self-regulation. This reminds me of the Financial Services Authority or any of the others, who levy money on people in financial services. Naturally what that does is to string them all together and then they actually can start talking about conspiracies against the public.

Another thing which people again can quote showing the argument that Smith was not as pro-business as he is made out to be, is the rapaciousness of landlords. I don't know how many landlords there are here – I know of at least one – and Smith says that landlords, like all men, love to reap where they have never sown, and he goes on about landlords. But again you see, this is the 18th century we are talking about. There wasn't such a thing as a market in property in the 18th century. It was very much the privileged classes owning the land and so on, and when you don't have free markets and free competition you can indeed get that kind of exploitation, so Smith was railing against something that is actually a phenomenon of monopolies, not of the market.

People say that he criticised corporations and joint stock companies. But again this is the 18th century. At that time you had things like the East India Company that had started as a private business but had grown into an agency of the State so that it had all the power of a private business and all the power of the State, with no competition at all. So once again I think this argument that Smith was a critic of business is much misunderstood and has been abused. His real gripe was against monopoly whether it was legislated by the State or whether it was promoted by private business. Regulation and coercion – that was what he opposed. He railed against business rigging the markets, but he railed against officialdom for promoting monopolies, and his view was that regulation just ossified things, and denied everybody the benefits of free trade and exchange. He argued that wherever possible you want to make sure that competition should be in force. The market economy is very powerful. It is like a fire, but you need a fire basket to contain the fire, and that is the role of government, to make sure that that competition is provided.

The second argument that Brown and his colleagues use is that of the invisible hand and 'let the market rule', but actually that doesn't feature very much with Smith. He only talks about the invisible hand twice and only in passing. Clearly this isn't central to his philosophy. Laissez-faire doesn't feature very much either. Also, since he does promote specific government interventions, like saying that there ought to be public works like bridges and things like that he is hardly a 'devil take the hindmost' capitalist. It is true that he was no supporter of laissez-faire (neither am I). I think it is a mistake of the Left. They exaggerate the fact that Smith hated elements of laissez-faire and elements of the capitalism of his time. He was not against capitalism as a system, and if capitalism worked with an open free competition, that was fine, and would benefit society. That was what Smith really wanted. He thought that monopoly and restrictions of any kind would undermine the mutual cooperation which was essential in the market system. As in his Theory of Moral Sentiments it is all about mutual cooperation – and governments must enforce competition to achieve that, and hence government does have a role to play.

On public works, all I would say is that Smith was not a tax-and-spend politician. He did believe that it might be necessary for the government to build bridges because the benefits were so widely spread but even here he did say that there ought to be tolls and things like that. He was only really interested in having government intervention if there were overspill effects which the market could not very easily capture.

The third thing that modern revisionists say of Smith is that his idea of sympathy in his Theory of Moral Sentiments, that we all have sympathy for each other (we feel what other people are feeling) is somehow at odds with the idea of self-interest in the Wealth of Nations, which they say is all about self-interest, all about greed, all about getting forward. And so the revisionists' view is that that's not the real Smith. The real Smith is this be nice to everyone else, understand them and be sympathetic to them person. That kind of stuff.

This is a complete 21st century misreading of the idea of self-interest. Self-interest is not greed. It goes back to the stoics. Self-regard is reckoned to be basic because only if you regard yourself, protect yourself and look after yourself, can you actually start doing things like helping others. Self regard comes first. If you neglect yourself, then you don't do anybody any good at all. We need others. We benefit from exchange with others. And therefore we are social creatures. If I were a psychologist I would say Smith regarded himself not as an economist but really as a social psychologist. This is what economics is all about. It is a social system and we need other people.

And so it seems to me that the Wealth of Nations, if you like, builds on and goes beyond what Smith wrote earlier. This self-interest principle goes beyond the idea of sympathy. In sympathy we help people because we see the direct benefits. In the market idea, the Wealth of Nations, we help them unwittingly. We buy from them and we don't realise that we are helping them, that they are benefiting, but in fact they are. And so all of that economic exchange generates wealth.

Three lessons for today

But coming back to the subject I was originally asked to speak about – What is Adam Smith's relevance to today? – *well, it seems to me firstly he tells us not to choke off the dynamism of the market through regulation because if you have regulation you thwart exchange and therefore you thwart the mutual benefit of exchange and you thwart the innovation of progress. Secondly he says don't kill enterprise through high taxes because once again you thwart innovation, entrepreneurship, you thwart progress and your society doesn't advance. And thirdly he says beware of politicians, beware of the 'man of system' as he calls it, who wants to fashion the world in ways which he or she thinks will fit their own design.*

So that is Smith's lesson. Unfortunately, on the first point, regulation, it seems to me that the European Union in particular isn't listening to that at all. Indeed they seem to assume that for every action there ought to be an equal and opposite regulation. On the point of taxation and the need for 'easy taxes' as Smith calls them, it seems to me that the likes of David Cameron aren't terribly positive about that either, and then, as regards avoiding 'the man of system', well the likely next Prime Minister, Gordon Brown, is a prime example of that. In other words, I conclude that Adam Smith is relevant but we must be careful to avoid those who find it convenient to misrepresent him.

GLOBALIZATION'S UNEQUAL DISCONTENTS

*By William H. Overholt – from Washington DC**

Protectionists who characterize free trade as almost treasonous are on a crusade to build new barriers around America in an effort to keep jobs in and imports out.

Some have built careers around denouncing the evils of globalization. CNN commentator Lou Dobbs, for example, criticizes free trade on a regular basis on his nightly show and in his book 'Exporting America: Why Corporate Greed is Shipping American Jobs Overseas'. A promo for the book on the CNN web site states: 'The shipment of American jobs to cheap foreign labor markets threatens not only millions of workers and their families, but also the American way of life.'

The most serious critique of globalization is the charge that it promotes inequality, driving down US wages while enriching millionaire corporate executives. This charge is partly true, but mostly false.

The true part is that within many countries, globalization has enhanced the wealth of business owners and managers while providing proportionately less wage growth for ordinary workers. It has done so by expanding the workforce participating in the modern world economy to include much of the populations of Eastern Europe, China and India.

As a result, millions of workers in the US and Western Europe now face more competition than ever before from others willing to work for far lower wages. Capital has not experienced a proportionate increase in competition, so the share of corporate profits has risen and the share of wages has fallen. The rich get richer, while incomes of workers as a whole go up as well, but more slowly.

Some manufacturing workers in the United States – such as those who labored in huge factories making basic steel – have suffered as they've seen their jobs leave America for low-wage countries. But for workers as a whole, the truth about globalization and inequality is the opposite of what the protectionists claim. There are three caveats to the steel worker's story and two larger perspectives on inequality.

One caveat is that protectionists enormously exaggerate the negative effects of globalization by attributing virtually all manufacturing job losses to

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- ***William H. Overholt*** *is Director of the Center for Asia Pacific Policy at the RAND Corporation, a nonprofit research organization.*

competition with China. We are told by union leaders and some politicians that America is exporting millions of jobs to China. This is absolutely untrue.

Scholarly studies show that most job losses in the United States are attributable to domestic causes such as increased domestic productivity. A few years ago it took 40 hours of labor to produce a car. Now it takes 15. That translates into a need for fewer workers. Protectionists who blame China for such job losses are being intellectually dishonest. In fact, both China and the US have lost manufacturing jobs due to rising productivity, but China has lost ten times more – a decline of about 25 million Chinese jobs from over 54 million in 1994 to under 30 million ten years later.

A second caveat is that there are two ways to increase people's standards of living. One is to increase their wages. The other is to decrease prices so that they can buy more things with the same amount of money.

The ability to buy inexpensive, quality Chinese-made shoes and Japanese-made cars at lower prices disproportionately benefits lower income Americans. The Wall Street banker who pays $350 for Church's shoes benefits relatively little, but the janitor who buys shoes for $25 rather than $50 at Payless or Target or Wal-Mart benefits greatly.

Lower prices due to imports from China alone – ignoring all other similar results of globalization – probably raise the real incomes of lower income Americans by 5 to 10 percent. That's something no welfare program has ever accomplished.

A third caveat is that the protectionists never mention the jobs created and saved by globalization. If General Motors avoids bankruptcy, as seems likely, one important reason will be the profits it has made by selling cars in China. The vast China market, and the ability of American corporations to expand and refine their operations, though a division of labor with China, creates many high level jobs in US operations ranging in diversity from Motorola to IBM to Caterpillar to Boeing to farming.

The first of the larger perspectives on globalization is that open economies adjust faster to their real competitive advantages, allowing them to employ their own people. The most recent US unemployment rate was 4.4 percent. France, along with other relatively protected economies, typically has twice as high a proportion of the population unemployed because their workers are stuck in inappropriate jobs.

Still more protected economies, like many in Latin America, often run much higher rates of unemployment – up to 40%. Economies more open than the US – like Singapore and Hong Kong – historically run lower rates of unemployment.

The worst inequality is between families whose breadwinners have jobs and those who don't. Globalization minimizes that problem.

Globalization has brought countries with about 3 billion people from subhuman conditions of life into modern standards of living with adequate food, basic shelter, modern clothing rather than rags, and life spans that are over 60 rather than under 45. (In the early 1950s China's life expectancy was 41 years, in 2005 it was 72.7 years. This is the greatest reduction of inequality that has happened in human history.)

In East Asia, this reduction of inequality has resulted from a wave of economic growth that has swept through Japan, Taiwan, South Korea, Thailand, Malaysia, and much of Indonesia. It is rapidly spreading across China, is well on the way in India and Vietnam and is coming to other countries around the world.

The world's fastest growth is occurring in some of its poorest countries, notably India, China and Indonesia. The middle income countries are growing faster on average than the rich countries. In other words, global inequality is declining fast.

It is not surprising when workers in industries undergoing adjustment complain about the pain of change. For many families, prolonged unemployment can wipe out their savings, cost them their homes and turn their lives into a nightmare. The suffering of these families can't be ignored.

But sound economics is based on facts grounded in objective analysis, not on emotion. Sometimes, what seems like a 'common sense' solution is not really very sensible at all, as is seen with the arguments of the protectionists. Even the best of intentions can, in the end, bring about the worst of outcomes. The protectionists' proposed policies would sharply increase the agony of unemployment.

America will not benefit if an increasing number of opinion leaders and elected officials use exaggerated, partial views of inequality to try to lead us into a future of slower growth, higher unemployment and greater world tensions.

Instead, America and its leaders should focus on how the nation can use the rapidly expanding economy to assist individuals who have suffered from globalization to get the education, training and opportunities in new industries they need to benefit rather than suffer from globalization.

2007 – PROBABLY AS BENIGN AS 2006

By Damon de Laszlo

Since October we seem to have been living in a balmy world – the weather has been kind, hurricanes in America did not happen, commodity prices have declined including oil, and a feeling of happy complacency and general well-being set-in in the run up to the New Year.

International politics have become rather surreal. Bush's drubbing in the American elections had made him appear powerless, to the glee of Liberals and countries unfriendly to the West. In Britain, Prime Minister Blair is more and more seen as an invention of public relations and media management. Photo calls, word bites, posed appearances, and managed events wear thin as the infrastructure of the State deteriorates; education produces a rising level of illiteracy and the health service spins inexorably out of control, the military is underpaid and ill equipped. Worst of all the Attorney General, the supposedly independent head of the judiciary, now appears to take orders from Downing Street – the list is endless. In Europe, the small rise in growth rate looks destined to decline as the Central Bank ratchets up interest rates and Germany raises taxes. The governments of Europe and America react to events and lack cohesion or the mechanism to create strategy.

The rest of the world, however, paints a more optimistic picture. China and India continue their dramatic growth with governments, particularly in the case of China, focussing on the long-term process required to improve the lot of their population. China's development is clear and fascinating. The current five-year plan has the strategies and the processes in place to deal with environmental pollution, health and education and includes the staggering proposition that industrial jobs in modern factories with equivalent housing will get three hundred million people into the earning economy and out of the abject poverty and the short life expectancy in farming. China seems to be inspiring the rest of Asia and India to raise their game. It is also beginning to intervene in the management of the dysfunctional countries of Africa. While this is motivated by the need for oil and other commodities, it will almost certainly be a good thing for the people of these countries, compared with the state of chaos now prevalent.

The wildcard in international terms is, of course, Russia. This one-man government with old-fashioned views of the world, smarting under the humiliation of its collapse in power that brought the end of the Cold

War, has found a new weapon. The rise in the price of oil and gas that is funding terrorism in the Middle East and around the world, is also giving Russia for the first time a weapon more effective than the bomb.

In economic market terms, it is the marginal supply or demand that moves prices in the market. The Russian Government policy of taking direct control of its gas assets and intelligently using that supply to negotiate with each State in Europe has been the most fascinating exercise in political economic domination possibly ever seen since the granting of monopolies by European Monarchs. In the space of little more than a year, Russia has gained economic control over the supply of gas and the pipelines of greater Europe, all achieved without causing even a ripple in the political consciousness of the countries it can now disrupt. In a word, if Mr Putin wishes to influence policy of any or all countries in wider Europe he can, by waving his hand over the gas tap.

None of these observations should be regarded as pessimistic, other than that current Western event-driven governments are proving no match for the countries with governments that understand process and strategy. Luckily China and Russia are, by and large, primarily motivated by the need, at least in the short term, to improve the lot of their people.

The conclusion, therefore, from the analysis is that 2007 will probably be as benign as 2006, with clouds perhaps gathering in 2008 – election years in the USA and Russia.

LETTER

A response to 'The Bank that Forgot Money' by Brian Reading (B&O Vol 36. No 3) from Professor Tim Congdon

Sir,

In his article 'The bank that forgot money' in the autumn 2006 issue of Britain & Overseas Mr. Brian Reading says, 'The velocity of circulation [of money] can swing quite wildly. My former colleague [at Lombard Street Research], Professor Tim Congdon, said in early 2001 that forecasts of a US recession in early 2001 were 'ridiculous' as money growth was far too rapid for one to occur.'

I have most of my Lombard Street Research work from that period and do not know to what he was referring. In fact, in my April 2000 Monthly Economic Review I warned that, 'A period of beneath-trend growth or, more probably, a recession will be needed in the USA to restrict inflation and to reduce the current account deficit to a manageable figure.' Mr. Reading is correct that at the start of 2001 I thought that the then prevailing rate of US money growth would be associated with at least trend growth in demand and said so in my January 2001 Monthly Economic Review. That was wrong, but I realised my mistake quite quickly and cannot recall at any stage using the word 'ridiculous' about forecasts of recession. It is clear from all my work at that time that I viewed a period of beneath-trend growth and/or a recession in the USA as inevitable.

Yours faithfully,

Tim Congdon
Huntley Manor
Huntley, Glos.

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