BRITAIN & OVERSEAS

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

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FOUR (CONTRASTING) VIEWS OF BRITAIN'S 'WELFARE STATE'

Britain's 'Welfare State', the provision by central and local government of pensions, social security, unemployment pay, benefits, social housing, local social services etc plus financial support for welfare-related organisations of all kinds, was debated at a meeting with members of the Economic Research Council on Tuesday 22nd April 2008. Contributions were made by Lord Giddens, architect of former PM Tony Blair's Third Way, Peter Lilley MP, Secretary of State for Social Security 1992–1997, John Bird CBE, founder of the magazine for the homeless, The Big Issue, and by author and journalist, Peter Oborne.

The Principles were and still are Sound

By Lord Giddens

I'd like to make one general statement about the welfare state to start with, and that is that you can't have a decent society without an effective welfare system. I think if you look around the world it is unequivocally true that that statement is a valid proposition. All decent societies have good welfare systems. But that is not the same as saying what kind of welfare system, and I would make the argument that cuts across the debate really, that we are living through a period at the end of the 'welfare state', or at least at the end of the welfare state as it was traditionally understood. The main reason is not that we can't afford it, it is that there are such tremendous changes going on in our society that you have to reform welfare systems radically to cope with them.

Let me just mention four aspects of the traditional welfare state which I think, whatever its virtues, were problems for it, and which we have to overcome today. First of all the traditional welfare state picked up risks after the event. If you get unemployed, the welfare state comes in to help you. If you get divorced, the welfare state is there to support you. As you get old, the welfare state will provide you with a pension. It is an essentially after-the-event risk management system, the traditional welfare state. Well, that won't do any more for reasons that I will mention shortly.

Second, the traditional welfare state was largely dominated by more affluent groups rather than the poorer groups it was set up to support;

affluent people find strategies of deploying welfare systems to their own advantage. The welfare state has not done as good a job for the poor and the deprived as it should do, and we have to work on this for the future.

Thirdly, the traditional welfare state is based on a 'doctor knows best' principle. That is a top-down paternalistic kind of principle. Here's a joke that probably won't make you laugh, but there are many jokes in relation to health: a nurse is standing by a patient and the doctor comes in and says to her 'Nurse, this patient is dead' and the man lying on the bed says 'No I'm not!' And the nurse says, 'You keep quiet, doctor knows best!' Well, that is the old system and that won't do any more in the much more open society in which we live today.

Fourthly, the traditional welfare state is based on a large degree of uniformity: uniformity in our culture, in our identity, and uniformity in people's lives. For example, there was a division of labour between men and women. Women largely gave up work after having children. They took care of children at home; the man was the breadwinner and so on. These assumptions no longer hold in the society in which we live.

So, we need a new kind of system today. As I am an academic I like to think in terms of what I call 'the social investment state'. We have to invest a lot more in people, a lot more in people's skills, empower people a lot more and break away from aspects of the old welfare state which don't really fit or even have become actually dysfunctional for the society in which we live.

So let me just put this conversely in terms of another four points:

Firstly a new welfare state or a social investment state has to be much more preventative. It can't just deal with risks after the event. You have to invest ahead of the event to cope with the issues we face. For example, we know that poverty can become established very early on, so that if you get a child from a poor background who is more intelligent than one from an affluent background, age three, by the time you get to about age six, the child from the affluent background will outstrip the child from the poor background in terms of its abilities and capabilities as that child goes to school. So you must have early intervention to cope with these issues. We need a more interventionist state and this is most important for a whole range of social problems.

Secondly the traditional welfare state didn't worry too much about industrial or economic policies. But in our globalized market place, which is highly competitive, investment in people's skills, investment in education, investment in people's capabilities, is not only important for citizenship, especially for poorer people I think, who actually do fall into the system more, it is also important for generating jobs and making sure that this country can be competitive in a wider world system. We have to find ways of breaking the middle-class stranglehold on the welfare state. Our policies for investing in poorer people have not really worked as well as they should. That sometimes means more radical policies than Labour has been prepared to take on board. For example, I think we should be experimenting with lottery systems for admission to schools because otherwise middle-class people simply play the system and buy houses in the more affluent areas and they exert choice whereas poor people can't exert choice. We've got a lot of work to do on those issues because we have failed the poor, I think, in our society. There are too many people who are disqualified from full participation in the society and the traditional welfare state has not done a good enough job on that.

Thirdly, you may not agree with me, but I am in favour of choice, competition, and decentralisation in the welfare state. I think the welfare state is too bureaucratic, too centralised, too unresponsive to people's needs, has not empowered people enough, has depended on the 'doctor knows best' mentality. Choice and competition are very controversial in welfare systems and of course you can't extend the principle everywhere, but those countries that have done best in their welfare systems, such as the Scandinavian countries, are the countries that have decentralised most; that have introduced these mechanisms most. You must recognise the state is not the same as the public sphere. You can deliver public goods often in a better way by using third sector groups and other groups to deliver what used to be delivered in a top-down way by the State.

Finally, diversity has to be a key aspect of how we manage welfare assistance. We know it's very, very difficult. We know it's very difficult to deal with the impact of migration, for example, which can affect poorer people adversely, but we have to be committed, in my view, to a multi-cultural society. A multi-cultural society does not mean a society where every group is free to get on with its own life – it means the opposite. A multi-cultural society means having citizenship ceremonies, making sure that immigrants learn English, have an overall commitment to the law of the land, and trying to get communities in relationships with one another rather than allowing them to become separate. It means the opposite of what it is often said to mean by critics of multi-culturalism. But we have no choice except to have an active multi-cultural society where we try to integrate ourselves within a consistent and over-arching identity. I am not so cynical about Gordon Brown's attempt to foster an overall British identity as many people might think.

In conclusion then, I support welfare systems, they are the condition of a decent society but we must reform, we must innovate, we must change, and those countries that have changed and innovated the most are the countries that are most successful in reconciling economic success with social welfare and equality. Scandinavian countries, even though they are small, are well ahead of the rest of the world in this respect. They have very high levels of employment, are very successful economically but at the same time they have low levels of inequality, the highest levels of social mobility and the highest levels of social protection. If you are prepared to change, you can have the best of both worlds.

The 'Welfare State' has become the 'Dependency State'

By Peter Lilley

I think the 'Welfare State' has been both a success and a failure. It has been a success in the sense that the welfare state, the Social Security system in particular, has slain one of Beveridge's great giants – the evil giant of want. It has been a failure in that, despite us being a richer nation, we are a far more dependent nation; far more people are actually reliant on the welfare state now than when it began. If I feared that there was a serious risk that people were going to uproot the welfare state, abolish it all, leave the poor to fend for themselves, grind their faces into the dust and so on, then I would focus today mostly on the successes of the welfare state. As I don't think there is any risk of that and I want to see improvements in the welfare state, I'll focus on the failures so far and the need for reform and further reform. The welfare state wasn't invented as a safety net. The ideal safety net would be empty because no-one would have fallen in it, or if they had fallen in it, it would have acted like a trampoline and they would have bounced back to somewhere near where they came from, or for those who, by their misfortune, ill-health or disability or whatever, cannot participate in the normal process of earning their own living, it would provide a generously high level of support. But in fact the welfare state in this country isn't like that. It actually offers quite a low level of support. The net is quite low but it is very full. There are lots of people in it and that wasn't expected at the time it was introduced.

So, what have been the worst failures of the welfare state over the fifty/sixty years it has been in operation? First of all, Social Security has grown in cost at twice the rate of the economy over nearly the entire period, (certainly in the fifty years until I came along!), taking an ever-growing share of national income, headed by the largest single Department of State – Social Security is bigger than Health, Education and Defence put together, and as a result was the main engine driving up the burden of taxation on the economy. And it has got that way, not because benefits are becoming more and more generous, but, as I said, because more and more people are becoming dependent on welfare and spending more and more time on it. And that dependency is really a far more serious cost than the financial cost.

There is, however, one *good* reason why there are more people dependent on welfare now than when it started, and that is simply that people are living longer but the State pension age has not risen, so people spend a far higher proportion of their life drawing pensions than was anticipated when the system was introduced. The obvious answer to that is to index the State pension age to longevity so that gradually, with people's life expectancy increasing by roughly a month for each cohort so the younger ones will have to retire later. I did make a move in that direction, indeed a massive step – the biggest single saving in Social Security or public expenditure ever introduced, and that was to legislate that the female pension age will rise to equal the male pension age over the coming decade and you can all look forward to that. If I hadn't done that, the burden of expenditure on Social Security would have risen even more dramatically.

Other reasons for growing dependency are less good. People have learned how to get on to the system. They have learned, sadly, that once on it, even though the level of benefits is not particularly generous, they can adapt to them; reduce their expectations, their hopes, their anticipation, and ultimately become trapped upon it. If you look at the prime working age male group – those between 25 and 55, you find a lower proportion of people in work in that group now than there were in 1990, and far lower than there were in 1960 or 1950. So something significant has happened. Above all, lots of people on unemployment benefit and people on incapacity benefit are spending longer and longer out of the labour market in that capacity. We have also seen a big growth in lone parenthood and probably the benefits system has contributed to that though is not the sole cause of the collapse of the family, particularly in low income households.

So what are we going to do, or should we do to halt it? There is no simple solution. Some people say, oh, can't you just make it more worthwhile for people to work than be on benefits and then they would voluntarily leave the system? A Government spokesman recently said 'we've done that, we have reformed the benefits system so it is now worth everyone's while to work. Everybody will be at least £5 a week better off working than they would be on benefits'. Now, that's not much of an incentive to get up out of bed on a Monday morning, to know that by so doing, and working 40 hours a week, you will be £5 a week better off than if you had stayed in bed. But there is no simple way; it is not that the Government is stupid or that they have missed the trick. There is no way you can increase that differential between what you can get in work for comparison with low-paid, low-skilled workers, and what you get out of it, without either being desperately cruel to those out of work, or hugely costly by extending benefits up the scale of income of those in work. So there isn't a simple way. You have to enforce conditionality. You have to say to people, actually if you can work, even if you are only going to be a comparatively small amount better off, then you have got to work as you will not be entitled to benefits in those circumstances. A recent pamphlet, published by Policy Exchange, called *Paying for Success*, suggested that you have got to incentivise the people whose job it is to help people off welfare and into work. At present, when someone gets off welfare into work, they benefit; the economy benefits; the tax payer benefits. The only people who don't benefit are those whose job it is in the employment services to help them get off welfare into work. So we ought to be paying them by results and harnessing both private and voluntary organisations to help that process of getting people off welfare and into work, and staying in work when they are there.

We should, as Lord Giddens said, decentralise. I went to Switzerland because it struck me as the most attractive welfare system in the world in that it has the fewest people on benefits but the most generous benefits for those who are on it – the ideal system. When I went there to try and find what it was, they said it is very complicated – each commune has a different system, each canton has a different system. There is a Swiss joke (you won't laugh, I'm telling you) – which is about the little boys in the playground in the International School in Basle, where they were discussing, as little boys do, where babies come from. And the Italian said, oh it's when your parents kiss that causes a baby, and the German said, no they come in briefcases, and the Canadian said, no the storks bring them and the English said, no it's when you shake hands. And they eventually turned to the Swiss boy and said, in Switzerland what's your explanation, and he said, it all depends on the canton!

So, I didn't really learn very much from Switzerland except that decentralisation works. We should encourage people to opt out of the system for their own insurance and their own pensions to as great an extent as possible, but no-one can opt out of their duty to support others less well off than themselves. The best social welfare system of all is a vigorous economy, one where enterprise creates new jobs, finds opportunities for people to invest their savings and so on. And we need an education system which is geared to encouraging people to leave school with skills and an attitude to serve rather than be served, and if we do all those things we shall perhaps halt the growth of welfare and make the welfare system more generous. That must be the ideal we should all look forward to.

We have to Dismantle Poverty – not Stroke it

By John Bird

I believe very strongly that governments create poverty. I believe very strongly that the governments of the post-war period have actually created a new kind of poor. They have created a dependent poor. There is nothing wrong with poverty, I assure you, as long as you get out of it. At the top of the table here, there are a number of posh people, but there are probably some people whom, if you scraped away the surfaces of a few generations, you would see people who were in the peasant class picking spuds or working in factories. In the twentieth century the size of the British middle class increased by about 70% – not my figures, but I believe them to be true. Imagine if in 1908, Sir Winston Churchill and Lloyd George, when they were tinkering around with the early ideas of insurance policies, unemployment benefits and all that – imagine if they had done what was done in the middle of the 80s, and that was to institute a benefits system (ie a social security system that had nothing at all to do with your contributions, which was the major tenet of the 1946 welfare state). Let's not forget the fact that the welfare state was built on the idea that you put in and you took out. But what happened in the 80s was they closed down all the main older factories – the engineering, the coal mines and the shipbuilding and all that, and I believe (if Lord Willie Whitelaw is to be believed) that when Margaret Thatcher was told that that would mean that a lot of people would be put out of work, Sir Keith Joseph said, then they should get benefit, and then this benefit would move them on. But there was no moving on.

Imagine if in 1905 they had introduced this glass ceiling which is the benefits system, which had no relationship to getting back into work, imagine if in 1905 they introduced what they did in the 80s, then what you would have now is a very small middle class – very few people getting out of poverty; and you would not have the manifestation of what I call 'Paxman-man'. There is a guy on television called Jeremy Paxman. Recently there was a programme about his family which showed that at the beginning of the 20th century his family were all in the workhouse, and if they had introduced that wonderful cushion, that wonderful feather bedding, that wonderful system where you don't have to work, for one generation, and then another generation, and now even another generation, you could be caught; imagine, Paxman would not be reading the news today because he wouldn't be a posh git; he would be down there with the hoi polloi picking spuds and things like that, wouldn't he?

In 1939, my mother met my father in a pub in Notting Hill. They have been dead 25 years and 35 years respectively. Their deaths have got nothing to do with the cost to the Chancellor of the Exchequer, to you and me, because even though my parents are dead, I have a number of brothers (and I am speaking from a personal anecdotal view) who have produced children who have produced children, who are on benefit for three generations almost. And this was because what we did was we turned the beautiful concept of the welfare state which would create social mobility, that would pick up the crème de la crème of the working classes, and take them into the grammar school system and all that, and you would have this churn, and you would have this social mobility _ and what we did was we robbed the core of social mobility, and it was done with the best of all possible intentions. And, as you know, the road to hell is paved with good intentions!

The biggest social crime of today is the vast amount of Government expenditure on poverty, with little result. A trickle of people come out at the other end of homelessness, prison and long-term unemployment. For the amount we put in (around £60,000 per year to keep a person in prison, on long-term unemployment or in hostels for the homeless), the return is negligible. We have produced these new poor, stuck in dependency. The least we can do is get them out of it.

There has never been a time in human history when the poor have lived for long on unearned income. The last time we had such a vicious outbreak of unearned income, if you look at the history books, I think was probably just before the French Revolution. And remember what happened then. We now have the despicable situation where we have robbed the poor of a future, and until we begin to dismantle property, until we begin to give the poor social mobility again, they'll be doing all sorts of weird things to themselves because they will be caught in a terrible world. I only visit my nephews and my nieces very occasionally, because they are all scum. The reason they are all scum is that they hate blacks, they hate Jews, they hate everybody. And the reason for that is that what has been taken from them is the need to provide for themselves and the need to learn social skills. The role of the breadkeeper has been given to the state. When I meet politicians, who want to pissball about and fart around with this that and the other, I want to tell them to stand back and say 'Hang on, we have created a new poor, when are we going to dismantle that new poor'?

The Travesty of Beveridge's Intentions

By Peter Oborne

I don't know all that much about the 'Welfare State' so what I did this afternoon was to go and look at the Beveridge Report. He calls his report a revolutionary moment in the world's history and he set out what we were going to do to kill the five giants on the road to reconstruction: want, disease, ignorance, squalor and idleness. You can see the passion there, you can see the passion arising out of the economic and social devastation of the 1930s, and you can see the marvellous ambitions of the Atlee Government which put into practice so much of what Beveridge recommended. You cannot deny that some of the giants have been hit. We obviously live in the most prosperous society we have ever known, prosperous in particular for the mass of the ordinary people. But it is pretty obvious that it hasn't worked in certain ways. We have got in this country – and I don't think this thing is new – a large section of the poor, the very people that Beveridge had in mind in his great document in 1942, the very people who they aimed to save who have been condemned. Everybody notices that who goes onto the bad housing estates, who walks the streets not of St James's but of other parts of London, who read the papers in which almost every week there is a new parable of the devastating world we live in – such as the ghastly story of Shannon's mother and her grim family. What we have ignored is one of the great warnings of Beveridge – that 'The state in organising security should not stifle incentive, opportunity, responsibility. It should leave room and encouragement for voluntary action.' And that is what it has not done. It has steadily taken away the element of moral hazard from ordinary hard-working lives, so you have a situation where you get so many pounds extra in the dream land of Gordon Brown for going out to work. The recent 10p in the pound debate is a perfect example of the problem we are talking about. By abolishing the 10p rate and replacing it by tax credits Gordon Brown is taking away the free will, the responsibility of poorer people because one is saying, hang on, you can't spend the money in the way you want to, we are going to give you credits to spend the way the State wants you to. This is the removal and the destruction of individual responsibility.

The other devastating effect of the welfare state has been the way that the state and its code of morality has replaced and attacked voluntary institutions. There is an hostility to institutions independent of the control of the state. You can go through them – the demolition of the Friendly Societies, the old Building Societies, all privatised by the Thatcher government, many of these in the 1980s, actually, the Trustee Savings Bank, this wonderful civic institution; one of our greatest institutions, the Pension Fund – destroyed by Gordon Brown. Save As You Earn pension fund - wiped out by the Labour government post 1997. But most important of all, the destruction of the family. Because you have taken away the moral hazard of caring for yourself and caring for your children, you have given that to the State, and their horrible, evil care homes where children are sexually abused, molested, pushed out on the streets for a life which John Bird knows from his personal, deeply-felt, and highly experienced life, should be condemned.

The replacement of the morality of individuals, of the family and of voluntary institutions by the morality of the State has been the most terrible effect of the 'Welfare State'. That is why it needs reform, not for the paternalistic reasons outlined by Lord Giddens.

POSTSCRIPT TO ‘CRACKS IN THE FOUNDATIONS?’

By David B Smith

Introduction

In April 2007, the Economic Research Council (ERC) published the author’s ERC Research Paper No 23 ‘*Cracks in the Foundations?: A Review of the Role and Functions of the Bank of England after Ten Years of Operational Independence*’. This was before the US sub-prime meltdown in August and the revelation of Northern Rock’s difficulties on 13th September 2007. ‘Cracks?’ as it will be referred to from now on had expressed concern about the problems that would arise if the Bank of England ever had to operate as a lender of last resort. However, this seemed hypothetical at the time. It was also just one of several concerns expressed in the paper about the workability of Britain’s post 1997 monetary arrangements. Even so, the very first summary point of the ERC's 28th April 2007 Press Release had stated:

> The removal of the Bank’s debt management and regulatory responsibilities was probably an error, in part because of the resultant loss of market ‘feel’ when the Bank had to act as a lender of last resort.

This remains the author’s view. The purpose of this ‘Postscript’ is to extend the analysis in ‘Cracks?’ in the light of subsequent events.

Lessons from Northern Rock

The collapse of Northern Rock commenced in the inter-bank market. However, it also represented the first retail cyber bank run in a major economy. This helps explain - but does not justify – the initially inadequate response of the UK regulatory authorities. Large retail depositors with internet and postal accounts removed their funds at the first sign of trouble. Northern Rock was therefore doomed even before smaller depositors formed the impressively well-behaved queues that attracted so much television coverage. It is now known that one twentieth of Northern Rock’s retail depositors controlled around one half of its non inter-bank deposits. For politicians who are tempted to intervene when a financial institution gets into difficulties what matters is the number of voters affected. However, what matters for the stability of the banking system is the volume of deposits. This has implications for how high any deposit insurance should go. One could safeguard the majority of individual depositors, but still face an economically debilitating collapse of several institutions, for example.

The issue of deposit insurance inevitably entails a discussion of the moral hazard involved. Here, it is important to distinguish between the responsibilities of: 1) depositors; 2) shareholders; and 3) the management of deposit taking institutions. In practice, small savers cannot know enough about the financial position of long established and apparently reputable deposit taking institutions to act as a check on their management. In this case, moral hazard does not arise if they are protected, since their behaviour is unlikely to change in response. The collapse in the value of Northern Rock shares has certainly reduced the moral hazard aspects of its bail out where the shareholders of other commercial banks are concerned, however. The main principal/agent problem that remains is how the managements of failed institutions – who seem to be largely beyond the control of shareholders – can be made to share the pain, if their recklessness endangers the organisation concerned. All too often, managers of such operations have walked away with country mansions, large pension pots, and performance related bonuses, which were completely unjustified by their feckless stewardship of the organisations concerned. Arguably, the management contracts of institutions that have to be bailed out should be declared void – this is possible because statute law takes priority over civil law – and senior managers should receive no compensation for loss of office. Britain's regulators should also be more aggressive in the pursuit of wrong doers. The perceived threat of legal proceedings can deter improper behaviour even if gaining a conviction is notoriously problematic and costly in cases of financial fraud.

It is now time to make some specific recommendations.

Deposit Insurance

The need to avoid future panics suggest that the present system of deposit insurance should be extended. It would appear reasonable to offer 100% cover for deposits of up to £5,000, then 90% up to £100,000, and perhaps zero beyond that point (the present upper limit is £35,000). There are economies of scale in managing money and it is socially inefficient to have depositors breaking their savings up into penny packets to ensure that they are insured. This, together with the speed with which funds can be removed from internet accounts, argues for a reasonably high upper limit to the insurance protection. The provision of unlimited 100% deposit insurance would act as a crooks' charter, however, and encourage people to place their money with irresponsibly run institutions. This is why only 90% coverage is being advocated for larger depositors. Northern Rock's top end '*Silver Saver*' account, for example, was offering 60 basis points more than its rivals. The prospect of a 10% loss should be sufficient to concentrate depositors' minds on the risks involved, while safeguarding savers from the risk of unpredictable financial wipe out.

Mandatory Liquid Assets Ratio Requirements

The 1988 Basle agreement specified the capital requirements of the world's banks and was designed to ensure that deposit taking institutions had enough capital and reserves to avoid a solvency crisis. However, Northern Rock was allegedly brought down by a pure liquidity crisis, according to the official account. Earlier generations were aware of the risk of bank runs, and there is a long tradition of central banks imposing liquid asset ratio requirements on their commercial banks in return for the provision of lender of last resort facilities. Such requirements normally specify that a minimum proportion of bank assets should be held in the form of short-term government debt, such as Treasury Bills, and balances with the central bank. Such requirements should not be too onerous, because that would encourage the growth of dubious secondary banks. However, there are potentially high social costs to a situation where commercial banks can easily expand their balance sheets while relying on the central bank to supply liquidity on tap. These include the risk of boom/bust credit cycles and serious macroeconomic instability. This externality explains why market forces cannot operate untrammelled in the banking sector, if depositors are protected by the state and bank directors do not have unlimited personal liability.

Before the introduction of Competition and Credit Control in 1971, for example, British clearing banks were meant to maintain an 8% cash ratio, and keep another 20% of their assets in government debt with a maturity of less than five years. It was not until the 1980s that all such balance sheet restrictions were abolished, following several reductions in, and re-definitions of, the required liquidity ratio. It is now worth considering whether the re-imposition of modest mandatory liquidity requirements of the order of, say, 5% of eligible liabilities should be a response to the enhanced deposit protection that now seems inevitable. One advantage of such requirements is that the Bank of England would know with certainty the value of the first tranche of assets that was being pledged as collateral in a lender of last resort situation. There is a risk with mortgage backed and similar securities that the collateral accepted by central banks is worth less than its face value, exposing the taxpayer to potential capital losses, unless the 'hair cuts' demanded by central banks are adequate. However, one danger that must be avoided is the imposition of such a large or abrupt increase in reserve requirements that it induces a collapse in money and credit growth and a recession. Any new liquidity requirements should be phased in and not imposed all at once.

Bank of England or Financial Services Authority?

The re-imposition of mandatory liquidity requirement should be accompanied by a decision to make the Bank of England responsible for supervising the deposit taking institutions whose liabilities are included in M4 broad money. Secondary institutions outside the M4 sector should not have their deposits insured by the state and people should be informed that placing money with them carried a default risk. This would also introduce a firebreak in the spectrum of liquid assets, and allow broad money to be more clearly defined and perhaps better controlled. In its heyday, the Bundesbank believed strongly in reserve asset ratio requirements as a useful additional tool that amplified the power of its open market operations (Deutsche Bundesbank (1990)). Another advantage of returning supervisory responsibility for M4 deposit takers to the Bank is that it would have better intelligence on the institutions that it might have to bail out, while leaving the chore of supervising smaller institutions to the Financial Services Authority (FSA). US Federal Reserve officials have stated recently that their supervisory responsibilities made it easier to know that they were not being palmed off with dubious collateral, when lending to commercial banks.

Macro-Prudential Regulation and Money Supply Targets

Recent years have witnessed a growing interest in so-called 'macro-prudential' regulation (Borio and Shim (2007)) because of concern that the Basle agreement capital requirements have perversely amplified boom/bust credit cycles. This is because commercial banks tend to be flush with profits during the boom phase, and find it easy to build up their capital and reserves, but the converse applies in the downturn, with the result that banks ration credit too stringently. The remedy that is now being suggested is that the capital ratios imposed on commercial banks should be varied with the phase of the credit cycle, being raised in the boom and reduced in the slump. Proponents of macro-prudential regulation believe that the authority operating such a counter-cyclical policy would need to be forward looking and that this role could only be carried out by central banks - since they are already engaged in forecasting. There seems to be an unacknowledged connection here between the desire to have the assets side of commercial banks' balance sheets growing steadily over time, to reduce the amplitude of credit cycles, and the late 1970s vogue for money supply targets, which were an attempt to control the rate of increase in the liabilities side of the balance sheet. Money supply targeting broke down in Britain because it proved impossible to control M4 broad money through interest rates alone. One reason is that the demand for interest bearing money balances rose when the interest rate paid on deposits went up, squeezing the economy through an increased demand for money rather than a cut in its supply. The use of monetary instruments, such as variable liquidity ratios, might have reduced these difficulties. However, such devices were never tried because such ratios were being phased out in order to encourage financial competition. A personal view is that a macro-prudential approach to financial regulation would be done better through liquidity requirements than capital ones. Macro-prudential considerations also provide another justification for the European Central Bank's second monetary pillar – this time as a device for heading off boom/bust credit cycles – in addition to its established role as a bulwark against the build up of inflationary pressures beyond the conventional forecasting horizon.

Caveat Legislator

Unfortunately, there is a long history of ill-considered banking legislation inducing a credit crunch and an economic recession. President Roosevelt's decision in the late 1930s to punish the banks for their perceived earlier excesses by increasing their reserve requirements stopped the recovery from the Great Depression dead in its tracks, and led to a renewed downturn. More recently, the 1988 Basle agreement caused most of the world's commercial banks to try to re-organise the assets side of their balance sheets away from lending to the private sector – where the capital requirements were higher – in favour of government bonds. The result was a global credit crunch, a collapse in the value of the collateral such as property whose price had been supported by earlier lending growth, a marked deceleration in OECD monetary growth, and the global recession of the early 1990s.

The long period of subdued growth in broad money that followed did, however, bring down OECD inflation and paved the way for the 'great moderation' that followed.

There are two further worries about legislative intervention. The first is that it can lead to the monetary authorities suffering 'regulatory capture' by the financial services industry with the result that rates are set with the needs of speculators in mind, rather than the population at large, leading to an inflationary bias. This has arguably happened to the Federal Reserve in the Greenspan and Bernanke years, for example. The second concern is that regulations, such as the Basle agreement, can induce financial intermediaries to 'game' the system and try to push lending off their balance sheets through opaque devices such as securitisation. There would be far less uncertainty as to the value of the underlying assets today, and the inter-bank market would not have jammed up, if this had not happened. Fortunately, there has been so sign of the implosion of bank balance sheets observed in the Great Depression, when the US money supply contracted by almost one third. Indeed, the year-on-year growth of the aggregate OECD broad money has recently been rapid and is accelerating. There is a risk that the world's monetary authorities have replicated the monetary laxity of the late 1960s and early 1970s, and let the evil genie of global inflation out of the bottle, while they have been concentrating on avoiding a re-run of the 1930s.

Finally, nothing has been said so far about international aspects of financial supervision or the Joint Consultation Paper issued by the Bank of England, HM Treasury, and Financial Services Authority in January 2008. This reflects the space available. On the first topic, one's suspicion is that other countries will also reconsider the case for liquidity requirements and there may be a general, and possibly Bank for International Settlements (BIS) co-ordinated, move in that direction. On the second issue, people are encouraged to read the Joint Consultation Paper, which is a remarkably chastened document, and canvasses external opinion to a praiseworthy extent. The main regret is that this consultation process was not followed in May 1997, before the weaknesses in the present system were set in legislative concrete. The moral, as in many other cases, is pass laws in haste, repent at leisure.

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FANTASY ISLAND (2)

A talk given by Mr Larry Elliot, Economics Editor of The Guardian, to members of the Economic Research Council on Wednesday 16th January 2008.

Dan Atkinson and I finished writing 'Fantasy Island'* about twelve months ago. In brief, the book is about the Blair years - he was the dream weaver of the decade from 1997 onwards and Brown was the sorcerer's apprentice. We never really bought in to the idea that Britain was the miracle economy that Brown cracked it up to be and now we all know that growth is forecast to be so small that, even it isn't a recession, it is going to feel like one.

Gordon Brown's case for good economic management during the last decade rests on five points:

i) That independence of the Bank of England has made the economy more stable and there has been a sea change in monetary policy since 1997.

ii) That monetary policy reform has been buttressed by tough fiscal policy reform so that we now have golden rules for finance which cannot be broken which has entrenched prudence into the economy.

iii) That the welfare of the workforce has put Britain back to work.

iv) That investment in the public sector has resulted in the regeneration of the public realm with massive improvements in education, health, transport … you name it – it's been improved.

* *Fantasy Island* by Larry Elliot and Dan Atkinson is published by Constable 2007. Paperback £7.99

v) That the supply-side inducements and tax credits and so on will lay the foundations of a knowledge economy that will build on this foundation of prudence and stability.

Let us look at each of these. There is some evidence on monetary policy that long term interest rates have come down, but there is now a body of work which shows that things would have been little different under the previous regime. It might have been a quarter of a point or half a point either way but the idea that there has been some sort of fundamental change in monetary policy is quite difficult to back up. Maybe it is a good idea to remove economic policies from the hands of politicians with all their desperate attempts to win votes but I don't think that there is much evidence historically that politicians did cut interest rates immediately before elections. It is much more the case that fiscal policies were relaxed before elections.

On fiscal policy I think you have to give Brown some credit. Up until certainly 2002 he built up some hefty surpluses during the boom time, during the period of the dotcoms which ended the 1990s and then he spent them during the downturn 2001–2002. That was a very sensible way of handling fiscal policy; he acted in a proper counter-cyclical fashion in the classic Keynesian way. The problem has been post 2002 when he should have been building up surpluses in the good times to be spent now that the economy is going down again. But the state of public finances is now deeply worrying.

Thirdly, on the welfare to work programme, most of the improvement in the north was the result of a big increase in public spending which includes public sector employment. It is ironic that a Government which eschews the idea of demand management should have found this the way to achieve its jobs and regional objectives.

On the public sector there has been a big increase in spending and in investment and there *has* been an improvement in performance – and so there jolly well should have been. The question is whether there has been an improvement in public sector productivity commensurate with the amount of public sector investment, and on that the jury is definitely out but there doesn't seem much sign of the taxpayer getting maximum bang for their buck or anything like it.

Finally there is the whole knowledge economy which to me is just white heat for the Armani suited generation. It is the same thing that Harold Wilson said forty years ago that Britain in the future was going to be caught in the white heat of the technological revolution and all that sort of stuff. This is an example of the 'Solow paradox'. Solow said that you could see the influence of computers in the US everywhere but in the productivity figures, but I say you can see the influence of the knowledge economy everywhere but in the balance of payments figures. The idea that we have suddenly discovered banking, insurance, consultancy and architecture over the last decade under New Labour is utterly fatuous. These have always been strengths in the British economy.

I am not against the notion that the future of Britain lies in being a 'knowledge economy' but if Labour was really keen on it you could have seen real progress in areas like environmental technology where the Germans, Swedes and Japanese are miles ahead of us. These are markets which are booming and likely to be booming in twenty years' time as climate change becomes more important and yet there has been no real evidence of the British Government showing any interest in these areas through tax changes or regulatory changes.

The real growth, by contrast, in jobs has been in terms of parking attendants, *Pret-a-Manger* assistants, CCTV operators, anti-smoking coordinators, and in snoopers, snitchers and social workers. This, rather than the increased employment of white coated scientists is the real world today.

I am pretty pessimistic. For the past five years the economy has been running on three big engines: the housing market, the City and the public sector. It is quite hard to see how any of these three engines of growth are going to do as well in 2008 and 2009 as they have done over the past three years. At best we are in for a period of sub-trend growth and at worst for a long period of cold turkey.

THE SINISTER NEWSPEAK THAT MAKES CYNICS OF US ALL

By Jill Kirby

'We do need to have a debate about it. We have to have a very big debate about this.' Harriet Harman, asked on the Today programme last week whether paid sex should be made illegal, used one of the favourite political devices of 2007: calling for a debate.

Rarely alluding to a discussion in Parliament, the call for a debate (or its close relative, 'a public conversation') is nowadays a purely rhetorical device. Especially useful for ministers being pressed on difficult or controversial subjects, it is a convenient way to imply that action will be taken when in fact nothing will happen. It also helps the speaker avoid stating a view which might prove unpopular.

Politicians, motivated by their desire to create a sense of purpose and importance, have always manipulated language. Official jargon enables them to baffle the public and to justify their existence, to disguise inefficiency or incompetence. But New Labour has taken this disguise to new heights. In its desire to solve every problem and by the huge expansion of its public relations machinery, this Government has blurred the line between words and actions. Talking about a problem has come to mean the same as doing something about it.

Over the past ten years, thousands of government publications and ministerial speeches have generated millions of words, spawning a new and often impenetrable vocabulary. Replete with sustainable aspirations and ambitious targets, they promise to use key performance indicators to address the issue, bring about step-change and implement a progressive consensus, to raise awareness and streamline joined-up delivery in order to fast-track transformation. But how many problems have they really succeeded in solving?

Reverse the order of any of these phrases, or combine them entirely at random, and you will have an equally meaningless but portentous announcement providing the full flavour of Newspeak New Labour style. Log onto any government web site, or pickup any government publication, and within minutes you will experience the deadening effect of this vocabulary.

Speeches by David Miliband are a particularly rich source of Newspeak but no front-bench politician is immune from the disease. What George Orwell described as 'euphemism, question begging and sheer cloudy vagueness' now dominate political discourse. The corruption of language has infected all political parties, is endemic in public services, and is rapidly spreading into the media.

This week, the Centre for Policy Studies publishes a *Lexicon of Contemporary Newspeak*, identifying some of the most prevalent examples. As the Lexicon explains, there are several strands to current Newspeak. The first, and probably most widespread, is management-speak. Thanks to New Labour's expensive enthusiasm for employing management consultants, their jargon resonates though the corridors of Whitehall: from best practice to benchmark, strategic framework to cost-benefit analysis.

Added to this is a layer of therapy-speak: holistic, empowerment, dialogue and closure all spring to mind. Then there is an echo of old-fashioned Socialism: the 10-year Plan, The People (The People's Budget, The People's Europe, the People's Government), Time of Change. Finally a dash of post-modernism, which provides narrative, cultural shift and 'truth'. The result, almost always, is hollow obfuscation.

Of course, it is amusing to puncture the self-importance of the governing classes by identifying their verbal weaknesses. But modern Newspeak, like its sinister antecedents, is serious in its implications. Many familiar words have been drained of their original meaning; in some cases their meaning has been reversed: 'Investment' now means simply expenditure. Describing users of public services as 'customers' implies they have purchasing power, when in fact they have none. 'Excellence for all' is a contradiction in terms. Being in 'treatment' under the national drugs scheme covers all drug users who have registered, only a minority of whom are being helped to get off drugs.

But perhaps the most demoralising effect of modern political Newspeak is that it makes us more apathetic about the possibility of better governance. Becoming more cynical about the ability of politicians to mean what they say, we are inclined to treat all public utterances with contempt. If 2008 brings forward a politician who delights in plain speaking, using clear, jargon-free language, then he or she will deserve to gain a huge popular advantage. That really would be a step-change.

Jill Kirby is Director of the Centre for Policy Studies. The 2008 Lexicon is available at www.cps.org.uk

THE BEST BOOK ON THE MARKET

Eamonn Butler. Published by Capstone 2008. H/B £14.99

Subtitled 'How to stop worrying and love the free economy' and with glowing reviews around the dust cover from Sir John Major, Lord Lawson, Andrew Neil, Trevor Baylis, Sir Clive Sinclair, Vaclav Klaus and others, this wide ranging 150 page summary of our knowledge of markets and market mechanisms lives up to its title. It is very readable, accurate, engaging and, by the simple device of placing technical terms in italics even though they occur as normal words in the text, neatly bridges the gap between common language and professional jargon.

The reader can turn firstly to the chapter headings – 'The amazing world of markets', 'How specialization and exchange make us rich', 'The instant messaging system of price', 'Killing the messenger', 'The driving force of competition', 'The rules of the market', 'Market failure (and government failure), 'The morality of the market' and 'How to grow a market'. My next 'dip' into a book is often to read the very last paragraph – and in this case Butler is referring to a market-stall lady in China who once mended his cloths. He thinks of her and muses 'However she fares, I'm sure it won't be income redistribution, nor the communism of the past, that will raise her and hundreds of millions like her out of poverty. It will be hard work, customer service, luck, incentives, ambition and enterprise. It will be the *market*'.

As an economist one recognises the theme and philosophy underlying the text. Much is owed to Hayek and the Austrian school. At times it borders on Ayn Rand and the author is Director of the Adam Smith Institute. This is acknowledged of course but Butler's great achievement is to have brought so many points from a huge body of knowledge into an elegant, seemingly elementary text; a composition formed and presented just when it really is needed. This is not a massive ground-breaking work like Keynes' 'General Theory' or Smith's 'Wealth of Nations'. To make a musical analogy, this is Beethoven's 'Fur Elise' rather than Holst's 'The Planets', it is Bach's 'Jesu joy of man's desiring' rather than a Verdi opera. This book is an apparently simple work, playable by a novice but which nevertheless has the qualities of a beautifully cut diamond.

To take just one example – Butler's reference to privatisation in the 1980s engages the reader with:

> About a third of the population lived in state housing. Each morning, we would wake up to the state radio station, switch on the light (powered by state-produced electricity), maybe ignite the state-produced gas under a state-regulated egg in state-produced water. Then as you took the state-run bus or your state-produced car (running on state-produced fuel) to the state train station, you might get stuck behind a state delivery company truck parked outside the state bank. How you might wish that you could just pick up your state telephone

and book yourself on the state airline to jet off (from the state airport, of course) to somewhere sunny. (page 143)

Times have indeed changed thanks to the greater understanding of markets which this book so neatly describes. I can only mention just three small points as suggestions for improvement. Firstly, where the purpose and value of *patents* is examined, mention could have been made that there is well documented evidence showing that this legal device leads to a bias towards ‘patent-ability’. Resources are devoted to inventing things that can be patented in preference to equally ingenious developments like lifts for underground train stations, which are hard to define for patent law purposes. Secondly, *money* is described as arising only from barter (the idea that someone invented money because it was more convenient than swapping chickens for grain) but a more thoughtful account could point out that chicken sellers who wished to feed them the grain probably asked to be able to supply the chickens due to the grain seller a couple of months later. The IOU given to the grain, seller could be passed to someone else – as money. Thus debt rather than barter accounts for the invention of money. Thirdly, the reference to London’s Congestion Charge as a market solution seems overgenerous. For the moment, the London Congestion Charge is just another tax, pushing a few cars away from their direct route onto the peripheral streets. Mainly it has given the Mayor of London a huge revenue base.

But the criticisms are trivial and the book a delight. So who should read it? I hugely enjoyed the style and persuasion which carried me along but as a long standing economist I didn't learn much that was new to me. That however, is beside the point. I wish that I had read it when I was young. Then (I now know, on reflection) I was such a sucker for falsities and assumptions. This book would have provided the strength and the reasoning for me to sift rather than just accept, what I was being taught. In short, no A-level economics course from now on will be complete (or truly interesting) without using ‘The Best Book on the Market’.

J.B.

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