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

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A TALE OF TWO RECESSIONS

A talk given by The Rt Hon Lord Lamont of Lerwick, Chancellor of the Exchequer 1990–1993, to members of the Economic Research Council on Thursday 6th of November 2008

Thank you very much Chairman, for your kind introduction, and thank you very much indeed for inviting me to be President of the Economic Research Council, especially following in the steps of someone like the deeply revered John Biffen, whom I thought was not just a lovely man, but a very profound man and a very wise man, and for me to follow him is a great compliment.

I suggested that the title of my talk might be 'A tale of two Recessions'. You see, I've suddenly discovered that I am an expert on the subject – on slumps and depressions. I have never had so many requests and this year people are offering huge fees – I think I ought to be listed in the Investor's Chronicle as a contra-cyclical stock.

Obviously from a personal point of view, I often reflect about the comparison between our present difficulties (I am very careful not to use the word recession; it hasn't actually happened yet. I shall be there on television when it does, but it hasn't happened yet); and the period of 1990-1993. In many ways the two are different. To start with there is no comparison because the dominant feature in 1990–1992/3 was the fixed exchange rate policy though actually I don't think the ERM caused the recession; the ERM may have deepened it, prolonged it, but it didn't actually cause it, and I am quite certain that there would have been a recession whether we had been in or out of the ERM in 1990.

I think an interesting point too about recessions is looking at the scale of them, and I often think of Harold Wilson who, you will remember, lost a General Election on the basis of a monthly figure for the balance of payments deficit which was represented by the import of two jumbo jets, and the election was fought on the basis of the balance of payments deficit and as he pointed out years later the deficit had disappeared after the statistics were corrected. And when you look at the 1990–1992 recession, it was thought of at the time as the deepest, most vicious recession for years. But actually, when you look at the statistics now, it was less than the recession of the early 1980s; it was something like 2.6% down on GDP compared with around 6% in the early 1980s and much less than that in the 1970s as well.

One of the questions that people ask me all the time – as if I knew – is how long do you think this recession will go, how deep will it be, and I was quite struck again, it wasn't just me who thought of the parallel between 1990–92 and now; I noticed that immediately the first negative figures came out, which was if I remember rightly, a 0.6% fall in GDP for the last quarter, people said, Ah, but Norman Lamont's recession was -1.2, as though that told one anything. It isn't going to go in a straight line, but the fact that we had in the 1990s recession the biggest quarterly drop at the beginning, doesn't mean that you couldn't have a recession that got deeper and deeper and deeper. I have no idea whether this is going to be the same figure or less, but I do notice that in the housing market it is already worse in certain respects. I remember I was sitting at a board meeting with somebody who is in the residential property business six months ago, and he said to me the drop in particulars delivered and contracts signed is actually worse now – and this was six months ago – than it ever was in the early 1990s, and frankly I did not believe him, I just did not believe him. And then I did a little research and found out that it was indeed true, that the actual transactions had been catastrophic in this recession. Actually I think the fall in house prices has also been faster so far; most people seem to think that we have come down in value something like 12–15% and most people seem to think that we might go as far as 20–25%, so I think the fall in prices is certainly worse than in the early 1990s and that will have a very considerable impact obviously on the general economy.

One of the things that has set alarm bells ringing in my mind fairly recently has been what I have read about freight and about the Baltic Exchange and the very sharp drop there because, if we do see – and I believe the Baltic Exchange has fallen something like 18% – if we really do see a drying-up of trade in a significant way, the multiplier effect, the dynamic effects of that will be extremely serious.

The Present Recession is Market-driven, not Policy-related and is Overlaid by a Banking Crisis

I think this recession, the present one, is different in two ways. Firstly, I think previous recessions since the Second World War, have usually been linked to policy; they have usually been recessions caused by a government attempting to get control of inflation again. I think that was what caused the recession in the early 80s and I think this characterised the Lamont recession (obviously it was within the framework of the ERM – but

actually the whole idea was to get inflation down from double digits to the European average). I think a lot of the recessions that we have had since the 1930s have been policy-related. But this recession is I think more market driven, it is more of an organic recession. It is, to coin a phrase, a 'boom-and-bust'; a bubble in house prices, and debt, which is going to need a tremendous correction.

The second thing, very obviously, that makes this recession different, is that it has been overlaid by the banking crisis. I say overlaid because I personally believe, at least in this country (well, I think the same is true of America) there would have been a slowdown, even without the banking crisis. The banking crisis was heavily linked to the bank bubble and to the bubble in property as well. You can't even separate the two, but what is alarming and what has caused all the talk about the 1930s and if this is a really different recession from other ones, is that it has been overlaid by a banking crisis.

Concern about Public Finances

Another comparison that has to be made between the two recessions is the state of the public finances. It weighs quite heavily on my conscience how bad the public finances became when I was Chancellor of the Exchequer, but actually they weren't that bad when the recession began and, as you will recall, in the late 80s we were actually running surpluses, we were running surpluses I think as late as 1989 and even when the economy slowed down, at the very beginning we were running a much more modest – I am referring to the annual borrowing figure – a much more modest deficit than we are now, and the policy that I followed in that recession was to allow what I called the automatic stabilisers to operate. That is to say we allowed the deficit to expand during the recession, not by deliberate decisions or discretionary spending, but by the fall in tax revenues, by the increased cost of the recession as illustrated by increased unemployment benefits; we did not offset those with cuts in public expenditure. So we allowed those costs of the recession to hit us, we allowed what I called the automatic stabilisers to operate, but we didn't actually have any increases in public expenditure – or no significant ones – that were designed to be counter-cyclical. Even so, the deficit went to 7% of GDP, and when I hear Gordon Brown and co talking about having a great spending programme, I just hope they remember how quickly the public finances deteriorated in the early 1990s because I think it is almost certain that that will happen again here.

Developments 1997–2008

Now, how did we get to this situation? What are the things that have gone wrong in the last decade? Well, one point that I talked about when you kindly invited me to talk to the ERC about a year and a half ago is, I think, that the terms of reference that were given to the Bank of England when it was made independent, were not quite right. I was the author of the original concept of the inflation target after we left the ERM, but it was altered in two significant ways by the Labour Government. The first was to redefine the inflation target in terms of a very narrow price index that excluded all reference to housing, which I felt uneasy about, and secondly, although Charles Goodhart rather criticised me for this and thought this was something that was inconsistent with the objective of the inflation target, I also said that I believed that the Bank of England's terms of reference should take into account the growth of money supply and the growth of credit. That was removed from the terms of reference, gradually, step by step. I began to feel very uneasy and I began to feel that this framework, which I had been partly responsible for, was going to lead to the most terrible bust, and so that of course is what we have had despite Gordon Brown's tremendous hubris of saying that he had abolished boom and bust. You might say, well does saying that boom and bust has been abolished matter, it's only words. Well, it is conceivable that some people believed him, and it is conceivable that some people acted on this. Nigel Lawson (a great friend of mine, not normally noted for his humility) felt the need to go out of his way in a Mansion House speech to say no government, not even a Conservative government can abolish the cycle, and he was always conscious that there was a cycle.

The first thing that I think has gone wrong is obviously that we have spent too much and borrowed too much. To me there's a bit of a mystery quite how the Labour Government got into the situation that it did. I have never entirely understood how it was that when they came to office, they said that they would stick to our spending plans (which to be honest we wouldn't have stuck to). We all had a tremendous intake of breath, we would never have been able to do that because Cabinet colleagues would just have revolted and not accepted it. But these very draconian spending plans that were really put in for illustration purposes rather than what we thought would actually happen, were accepted by Brown and Blair who stuck to the illustrative bottom line for the first three years and for a bit longer. Then they suddenly went mad and went into this tremendous spending splurge. I have never been able to understand this. Was this a deliberate attempt

somehow to get the confidence of markets, to deceive the public, and then to do what they really wanted to do? I think that seems rather improbable. Another explanation is simply that they believed their own fiscal rules that they set up and as I just want to say in a minute, those fiscal rules I believe were wrong-headed, badly framed, and the fiscal rules led them into this tremendous march. It has been almost unbelievable how they have spent money and when you add on the PFI, the misuse they make of the PFI, then the fiscal position is much worse than they have said.

The other thing that I would say they have got badly wrong are the fiscal rules that they invented for themselves, which were if you remember to borrow mainly to invest and to balance the current budgetary account over the cycle. I think those were always rather suspect rules, firstly because I think, whatever sense it may make in commerce, the distinction between capital and current spending is very difficult to make in government finances. For example, is teachers' pay current expenditure or capital expenditure? It is very easily fudged and I never thought it was a good distinction to make. As for balancing current expenditure over the cycle, that of course made no sense because they themselves chose to define how long the cycle lasted, and as you will recall they several times altered the time that the cycle was meant to represent.

The Future

So those are the things that I think have gone wrong. What are the things that we could do now? It is a very, very difficult situation. One of the things that one has noticed strikingly in the last few weeks is the sudden reappearance in the newspapers of the great Lord Keynes and lots of people, who I suspect have never opened a volume of any of Lord Keynes's works - Alistair Darling said the other day that a lot of what Keynes said made good sense. Well I think we all agree with that, Lord Keynes was a very great man indeed; and then the Prime Minister started talking about having a £100 billion package of borrowing, which rather alarmed me, but when I reflected on it I rather came to the conclusion that possibly what he meant was, since the deficit was probably going to soar to £100 billion anyway, he would call it the Keynes's package. That was how I tried to comfort myself that that was probably what he meant. As everybody in this very knowledgeable audience knows, Keynes did indeed believe in deficit financing in a situation where the system was not self-correcting, and where there was a depression, and where interest rates were ineffective. But Keynes

never said that this should be done through the public sector and, as you will know, all sorts of students of Keynes, including Ben Bernanke, have advocated, if Keynsian remedies were necessary, simply dropping pound notes from helicopters. It doesn't need to be done through the public sector. I think it would be justifiable to let borrowing rise in the way that we did in the early 1990s, what I call the automatic stabilisers. I think we had a stronger case then for a Keynsian package than now because in the early 1990s we were deprived of two important tools of policies, they were (1) the exchange rate and (2) interest rates and, to my mind, it is much more important actually to get interest rates down and to get the exchange rate down. I think that is a far better tool than to increase public expenditure. And I think increasing public expenditure through infrastructure projects would probably do very little for the economy. A lot of these projects are public sector projects, probably not very efficient; they are very unwieldy, it is very difficult to bring them forward. They are not, many of them, nearly as labour intensive as people think, they have been highly mechanised. But above all, the timing of them is usually wrong. By the time they come on stream the economy has moved on and the situation is completely different. So I would say it is far better to get interest rates down, far better to take advantage of a lower exchange rate, though of course we have to be careful that we don't get some dramatic collapse in the exchange rate.

I think what we also have to bear in mind is that borrowing is already extremely high. I referred earlier to how in the 1990s' recession when I was in charge we got to a 7% of GDP deficit. That was £50 billion. I think in today's prices that would be equivalent to £70 billion, somewhere around that. People are talking about a £70 billion deficit for this year – I think it was £34.5 billion for the first six months of this year. But of course the difference between the £50 billion I had, translated into £70 billion today, and £70 billion now is that my £70 billion was after the recession was over, after the full costs of the recession had hit the tax payer. People are talking about £70 billion now, possibly £100 billion the following year, and as everybody here is very well aware, interest payments do have to be paid for. It is very striking how a large annual deficit can suddenly, dramatically change your position in terms of the total stock of debt that a country has and the interest payments that have to be made if you are talking about sums of £100 billion or so.

At the moment, I believe the position, according to the Institute of Fiscal Studies, is that our debt to GDP ratio in this country is about 43.8% of GDP, which actually is the same rate that the Labour Government

inherited from us, but of course with us it was a post-recession figure, with them it is a pre-recession figure. If you add on to that 43.8% the equity injection likely to be done in relation to RBS and Lloyds/HBOS, that takes you up to 50% of GDP. 50% is a figure we have not had in this country since the 1970s, since the time of Jim Callaghan. Even so, it would remain well below that of most other G7 countries, but if you add on the guarantees that the government are giving in order that banks can raise more capital, if you add on the contingent liabilities of the banks, you can easily make calculations of 100 or 200% of GDP, and I think we do have to be careful in just thinking, because we have only got 50% of GDP represented by debt we have innumerable and unlimited headroom. I think in a world where capital flows are going to become more nervous about financing budget deficits and balance of payments deficits, we do need to be extremely careful.

The Banking Crisis: a Failure of Supervision and Regulation

I said earlier what made this crisis different was the banking situation. It is perhaps understandable that some mistakes may have been made, but clearly there was a failure of supervision. I personally think it was a great mistake to remove supervision from the Bank of England and hand it to the FSA. I think either it should have remained with the Bank of England, which I personally would have preferred, or it should have been in a separate body from the FSA. In the old days the Bank of England was responsible for financial stability in a macro sense and monitoring the banks, the Governor knew what was going on. Of course it was a different world, I am not harking back just to the wonderful old days of the accepting houses when the Governor knew everybody personally, but I think the Bank of England still probably had a much better understanding of the working of the inter-bank market and of banking markets generally than the FSA. So I think there was a failure of both supervision and regulation and I think the rules of capital adequacy for banks have clearly been found wanting.

In my opinion we do not need a return to a global fixed exchange rate system, but I think the government did the right thing in helping the banks. The size of the rescue is obviously awesome but when you look at it in terms of previous bank bailouts – Scandinavia, Thailand – it is sort of similar as a proportion of GDP to what is happening to us – much less actually than that of countries like Thailand. There is a chance – I say a chance, there is a possibility, maybe quite a good possibility that you will get

quite a lot of the money back, but there is a risk that we won't. But I am myself quite troubled by the relationship between the government and the banks. The most important thing is that banks should start to lend to each other, and there have been encouraging signs, both in European markets and in American markets that inter-bank rates are coming down and that lending is being resumed. But of course it is happening with rather artificial conditions. People are lending under government guarantee, when what is actually wanted is for people to lend without guarantee, without support.

The Troublesome Relationship between Government and the Banks

There has been a lot of talk about the treatment and valuations, market to market, and people are talking about how this could spiral downwards and this is something I am really not an expert on but I just follow out of interest; I left 39 international accounting standards, 39 about market to market, and I noticed that on 13 October, these were relaxed, relaxed because of the pressure of quite a lot of politicians, and as a result of that the other categories by which impaired securities can be valued, either held till maturity or for sale, which enables more companies to retain securities on their balance sheet and not put them through the P&L and I am a bit worried about this because there is a slight element of 'shooting the messenger'. If market to market was wrong during the bull market conditions (as it may have been) it certainly was quite an influence in pushing valuations upwards; and it may be an unwelcome influence now in pushing valuations downwards. I was a little disquieted when I noticed Deutsche Bank just a couple of weeks ago were the first people to exploit this new relaxation in accounting standards. They managed to change something like €800 million and translate a loss into a profit; and I noticed that RBS despite some very considerable write-downs, saved £1.2 billion just by taking advantage of this different method of valuing impaired securities. Of course, whichever method you use, it doesn't alter how much money you owe or how much interest you have to pay. It may alter your book value, but the question is, is your book value correct? I am just a little bit worried that we are not grasping the problem. I hate the fact that the government is a shareholder, probably a majority shareholder in RBS, such a big significant minority shareholder in Lloyds/TSB, and the only shareholder in B&B and Northern Rock. But I think the important thing is that the government ought to use its influence to get the scale of the losses out into the open as quickly as possible, to get it over, and just using all sorts of accounting

devices to conceal or to make things look better than they are, I think is to repeat the mistake that the Japanese made early on with their bursting of the bubble when they refused to acknowledge the losses they had in their banking system, and as a result the whole crisis went on and on and on. I hope that the government (and I think it would be legitimate for the government as a shareholder in the banks) will use its influence to get the bad news out so that we can start rebuilding in the banks.

The Need for Strong Banks – not 'Political Lending'

The government has stated that lending available should be at the 2007 levels. Of course the banks need to support small businesses, medium businesses, manufacturing, but above all we have got to have healthy, strong banks in this country and our banks are in a weakened state and we need to rebuild the balance sheets of the banks. I am concerned that we will get political lending. I noticed one of the first things that happened after these stakes were taken in the banks was that the banks were summoned to provide more money for the government's shared equity schemes in houses – no doubt a very admirable social objective, but if the banks didn't want to do it, do we really want to weaken the banks further by forcing them into making loans which in their judgement will not be commercial loans? I think we have to accept that we have had the banks weakened by the credit crunch and yet there is a second credit crunch that may yet hit us, that is the bad debts that will come from the slow down in the economy. What we have got are the bad debts from the credit bubble, but when the effect of that and the slow down in the economy come back on the banks we will have further impairment of their balance sheets.

Remuneration Packages Need to be Consistent with Proper Risk Management

The third issue that I think is very important – I assure you I'm not descending into tabloid journalism here – but I think the issue of pay is a legitimate issue. Not the quantum of pay, that's for the shareholders, but what has worried me has been the structure of some remuneration packages, which I think have not been consistent with proper risk management and have encouraged people to place very large bets for their own very personal short-term advantage, but not those necessarily of their clients or of their shareholders. I don't know quite what the answer is. The FSA

are toying with the idea of having capital requirements that have some link to remuneration packages – that seems to me a little heavy-handed but I think this is a risk management issue and it is an issue that needs in one way or another to be addressed.

A Conclusion

I think getting the inter-bank markets moving is the most important thing. I am very much opposed to a Keynsian package. I don't want to see a large public expenditure or a public works package. I'd rather put any money into getting the inter-bank markets moving. I think that would be a far better investment.

I don't myself believe we are facing a 1930s situation. I think there are many differences between now and the 1930s – policy is more accommodating fiscally, in monetary terms as well, and the fact that the banks have been rescued whereas, as you know, in the 1930s in the United States a very large number of banks were allowed to fail. So I think these are very different situations from the 1930s and I think the appropriate responses are relatively modest ones. We have unfortunately to take a hit. We have to live through a period where debts are unwound and it will be painful and it will be difficult to sustain demand when that is happening. We are going to have quite a protracted slow-down. If there is a silver lining – I am sorry this has been such a gloomy talk – but if there is a silver lining we should remember Professor Schumpeter's analysis that recessions are how capitalism, with its streak of destruction, reinvents itself, and I think we will reinvent ourselves and come through it. I don't believe this is the end of the universe or the 1930s at all.

UK ECONOMY: A CRISIS BUT NOT A CATASTROPHE

*By Peter Warburton**

On the basis of preliminary data, it has been reported that the output of the UK economy fell at an annualised pace of 6% in the final quarter of last year, to stand 1.8% lower than a year ago. This piece of news must be set in the context of annualised outturns, or expected outturns, for the fourth quarter that range from Canada and Norway (between 0 and -3%), Germany and France (-4% to -5%), Japan (-7% to -9%) to Singapore (-16%) and Korea (-21%). It is very probable that the most recent and current quarters will be seen as outliers in the evolution of this crisis but, on a matter of semantics, the UK economy – and most of the world economy – is already in depression.

This shocking UK outcome was unthinkable to most professional commentators even three months ago. Indeed, in late-November, HM Treasury predicted the mildest recession since World War 2 in its Pre-Budget Report. David Blanchflower, one of the few members of the Bank of England's Monetary Policy Committee (MPC) to emerge with his credibility intact, summarised the situation in an interview with the *Sunday Times* thus: "Economics missed this. One of the things I'm struck by is how silent economics has been through this because it doesn't fit well with the models."

Depressions are illnesses of the credit system and cannot be remedied by the medicines designed to cure business cycle downturns. Migraines encompass the symptoms of headaches, but a migraine is not merely a bad headache. Similarly, a protracted downturn in the global credit cycle differs in character from a business cycle downturn involving consecutive quarterly falls in the level of Gross Domestic Product. The first step to recovery begins with a diagnosis that embraces reality, however unpalatable. This article considers why economics "missed" the approaching downturn, not only in the UK, but around the world; describes the multi-dimensional character of the prevailing crisis, and suggests some principles of crisis recovery.

Four indictments of conventional macroeconomics and policymaking

For a young subject, economics has a remarkably short memory. Rapid accumulations of credit have invariably preceded financial distress and

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economic dislocation, with the most recent examples offered by East Asia in 1997 and Japan in 1989-90. The economics profession has suffered a glaring lapse of concentration in failing to recognise the proliferation of global credit since the early 1990s as a significant macroeconomic development. Whereas national monetary data are collected, collated and published on a timely basis, national and international credit data have been more elusive and slower to appear. For many years now, the Bank for International Settlements has largely filled that gap and yet economists persist in treating credit, in its fragmented contexts, as a branch of microeconomics. In failing to assemble the whole credit puzzle, the progressive leverage of the global economy has been disregarded as an explanation of unusually stable and persistent economic growth.

Second, the inflationary experiences of the 1970s and 1980s seem to have bred an aversion to the understanding of credit and monetary processes in favour of a black-box, or reduced form, approach to the determination and control of inflation. The adoption of a formal UK inflation target in 1992 fostered a steady decline in the monitoring and analysis of credit and monetary processes and developments. For the past 10 years, the growth of UK banks' balance sheets has appeared to have a zero correlation with inflation outcomes, whose target compliance has allowed members of the MPC to assert, or at least infer, the irrelevance of credit and money developments. Suddenly, when the world is overtaken by a fracture of the credit system, the authorities are unprepared and ill-equipped to deal with the situation. Eighteen months after the eruption of the crisis, their policy responses are piecemeal and incoherent.

Third, academic research has adopted a dismissive attitude to time series analysis of macroeconomic phenomena, preferring the controlled environment of abstract models, such as the famed Dynamic Stochastic General Equilibrium (DSGE) model. As an econometric modeller of old, I can testify to the difficulty of fitting economic hypotheses to the empirical data. It is a messy business, involving frequent reformulations, shifting parameters and ad hoc adjustments. However, macro-modelling stimulates the search for valid and relevant economic hypotheses. As elegant as the analytical models may be, they require assumptions of breathtaking naivety. My understanding is that DSGE assumes a zero or negligible incidence of credit default and delinquency. The very problem that confronts us has been written out of the script!

Fourth, the dominant influence of such models has emboldened governments to frame policies that work within theoretical constructs but not

in the real world. A willingness to interfere with market processes has blinded them to the dangers of moral hazard. The success of inflation targeting has been based upon the assertion of a common understanding of the economic model and an implicit contract whereby agents trust the monetary authorities pledge to correct any material deviation from the inflation target. As a psychological tool, inflation targets have scored some notable successes, but absent a complementary framework of credit and monetary control, the policy was doomed to failure. In using target compliance as an excuse for abnormally low nominal interest rates and by ignoring the widening gap between the growth rates of aggregate credit and broad money, monetary policy in the UK and elsewhere set a course for financial instability.

Four dimensions to the present crisis

The UK's economic crisis can be likened to an exotic plant that has not flowered for more than 15 years. Many adults have never seen the flower at first hand. Finally, when all the conditions are fulfilled, the plant sends forth a bloom of startling complexity and size. Indeed, there are four dimensions to the prevailing crisis. First, and foremost, there is a crisis of credit: a crisis of mortgage debt, corporate debt, financial institutions' debt and even sovereign debt; a crisis of financial leverage, of disintermediation and of securitisation. Second, there is a monetary crisis: a bank liquidity crisis, an unsecured money market crisis, a corporate liquidity crisis and a household cash-flow crisis. Third, there is a crisis of aggregate demand: slumping consumer expenditures, deferred and cancelled capital spending, inventory liquidation and receding export volumes. Fourth, there is an aggregate supply crisis triggered by a loss of corporate profitability, a disruption to credit access and the rapid substitution of private sector provision with public sector provision.

Depending on one's economic and political persuasions, the reader will be drawn to one or other aspect of the UK crisis. The Austrian school of economic thought is attracted to the credit crisis; the monetarists to the liquidity crisis; the Keynesians to the demand crisis and supply-siders to the supply crisis. Each school of thought brings its particular diagnosis and prognosis of the problem. Unfortunately, we must confront a multi-faceted crisis that calls for a comprehensive response, accepting that the best response to some aspects of the crisis could well be studied passivity. In the next section, six principles of crisis repair are proposed.

Six principles of crisis repair

A. Maintain the integrity of sovereign debt at all costs

When dealing with an economic depression, as in wartime, different principles apply. This is not a time for partisanship, either political or ideological. The foremost asset of a nation in time of crisis is its creditworthiness. Its currency may go to the dogs, at least for a time, but its credit must be upheld. While the government must, of necessity, run a much larger budget deficit as private markets malfunction and it assumes greater economic responsibility, the road back to fiscal integrity must be clearly delineated. This amounts to a commitment to pare back the non-essential functions of the public sector and to raise the general tax burden as required. Mere assertions of rising tax revenue based on future economic growth will not suffice.

The bank bailouts of October 2008 and January 2009 hold the potential to raise the public debt to GDP ratio from 50% at end-2008 to around 80% at end-2010, allowing 8% of GDP for the Treasury Asset Protection Scheme (TAPS). Arguably, this is too rapid an escalation of public debt to be funded by the sales of government bonds to the UK non-bank private and overseas sectors alone, particularly at a time when other sovereigns are ramping up their primary bond issuance. By failing to articulate the necessity for UK banks' own shored-up balance sheets to be used to part-fund the bailout, sovereign credit risk has increased markedly since the first plan was released. For comparison, figure 1 shows that the UK sovereign CDS spread of 145bps on 23 January was closer to that of Spain, 150, and Italy, 185, than to Japan, 46, Germany, 63, or the US, 70.

Having fluffed the fiscal challenge in November with a nonsensical VAT change, there is the danger that the UK's sovereign credit will be impaired further by ill-considered laxity in the forthcoming Budget. The government should not expect the extraordinary cheapness of its funding at present to persist for more than a few months. While Moody's and Standard & Poor's have recently reiterated their top ratings for UK senior sovereign debt, these are mere opinions. To quote Moody's, "it is a calculated risk and, in our view, a better option than passivity."

B. Segregate the worst vintages of toxic assets and recapitalise banks that are otherwise solvent

When credit markets fail to price credit rationally, without due consideration of future loss, huge problems can arise in a short time span. Most episodes

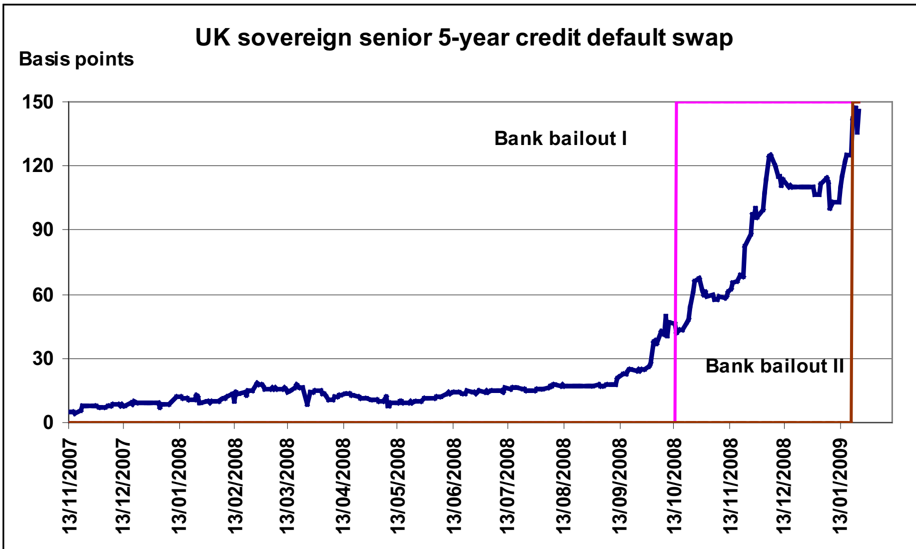


Figure 1: UK sovereign senior 5-year credit default swap
Source: Thomson Reuters

of wayward credit culminate in one or two years of utter recklessness, during which a substantial fraction of the lending losses are incurred. The 1989 vintage of UK mortgage lending proved to be the pinnacle of folly in that cycle and the one most culpable for eventual banking losses. This time, it will be the 2006-07 vintages. The Swedish example of the early 1990s argues for the segregation of the worst vintages of impaired and likely-to-become-impaired loan assets from the banking system. Identifying the vintage avoids the need for multiple qualifying conditions and allows the segregation to be achieved more easily.

Recapitalisation initiatives, whether from the public or private sectors can proceed more confidently once this segregation has occurred. The impaired assets can be held in a state-controlled vault until they mature, default, or until such time as they cease to be impaired. Even at the second attempt, the Treasury has refrained from taking the segregation option, in favour of TAPS, a far more complicated and awkward solution to banks' toxic assets.

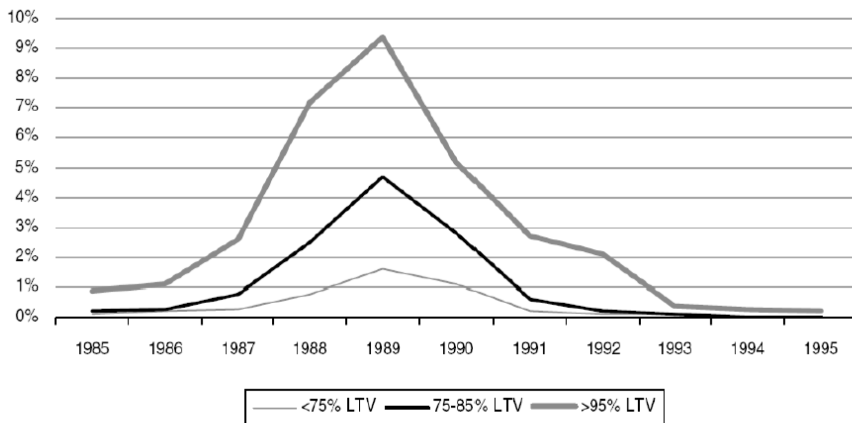


Figure 2: Cumulative loss rates by year of origination and loan-to-value ratio

C. Deal directly with the problem of banks' maturing wholesale funding

A welcome feature of the second bailout plan was the Guarantee Scheme for Asset Backed Securities, to provide full or partial guarantees to eligible AAA-rated ABS backed by mortgages, corporate debt and consumer debt. This is a belated response to Sir James Crosby's report of last November. However, the heart sinks to read that "the scheme will commence in April 2009 subject to (EU) state aid approval". As the Crosby Report table clearly shows, there is great urgency in dealing with the pressures on the banks of rehabilitating maturing residential mortgage-backed securities (RMBS) for which there is no longer a functioning market.

While the Special Liquidity Scheme that was introduced last April allowed banks to securitise existing mortgages and exchange them for Treasury Bills of up to 3 years maturity, it did not address the issue of maturing funding. As a consequence, banks have been preoccupied with the burden of replacing external funding with internal funding. The dramatic reduction in net lending to non-financial corporations and households has arisen, in part, because of the banks' prior commitments to rehabilitate loans that had been financed in the wholesale markets.

D. Facilitate corporate debt-for-equity swaps where feasible

Debt instruments that trade according to their price rather than their yield, or yield spread, display equity-type characteristics and should be treated as

	RMBS	Covered Bonds	Total
2008	56.5	-	56.5
2009	46.4	5.1	51.6
2010	48.0	5.4	53.4

Note: - symbol indicates that the amount is negligible.
Source: UBS, JPMorgan and HM Treasury calculations

Figure 3: Volume of maturing AAA-rated securities (£bn)

such. Given the depth of the corporate credit crisis that developed from September of last year, virtually all US sub-investment grade debt has a spread of more than 1000 basis points over its Treasury benchmark. This reflects a very high probability of default within the next few years. In recognition of that fact, the conversion of debt into equity should be welcomed. Typically, equities are more easily and regularly traded than corporate bonds, and companies require the flexibility to abandon dividend payments in this business climate.

E. Monetise securitised assets at their prevailing market values

At the most basic level of understanding, the remedy for a surfeit of credit is asset creation, not credit creation. Given that physical capital cannot

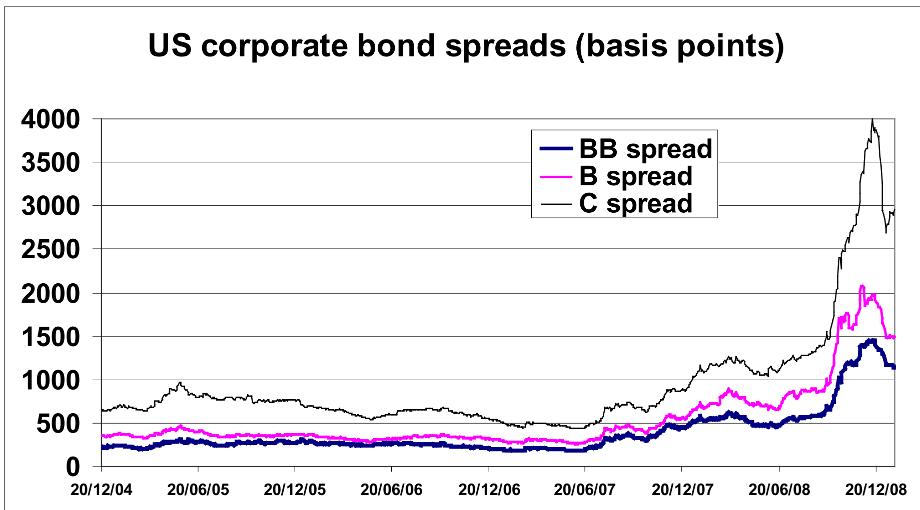


Figure 4: US sub-investment grade bond spreads over US Treasury bonds

be summoned forth from the ether, and that human capital involves a minimum gestation period, the only assets that can be created *ex nusquam* are monetary assets. When credit loses its purchasing power, people turn to money. When financial confidence is high, certain types of credit become close substitutes for money but when confidence vanishes, so does the moneyness of credit. When businesses fail, their creditors demand the liquidation of the business assets, not the securitisation of those assets.

Excessive financial, corporate and household leverage can be unwound in a number of ways – debt forgiveness, debt default, debt socialisation and debt monetisation – but the very scale of UK debt excesses suggest that monetisation will prove the most socially acceptable mechanism for de-leveraging the economy. The size of the banks' customer funding gap – over £700bn at end-2008 – implies that it would take many years for customer deposits to fill the gap in the context of very low inflation and interest rates. The fulfilment of an inflation target has ceased to be the top priority: the unwinding of our perilous financial condition will most probably occur through a significant bout of general price and wage inflation.

F. Underfund the public sector budget deficit

During the second half of 2008, the increase in the demand for default-free government bonds far exceeded the increase in their supply, despite the additional spending commitments that governments had announced. The extraordinary degree of risk aversion on the part of institutional and retail investors offered the opportunity to sell ample amounts of government debt, even beyond that which would be required to match the budget deficit. In the UK, the Debt Management Office allowed this excess of funding to reach over £20bn. However, by draining liquidity from the non-bank private sector, the government was unwittingly aggravating the cash-flow pressures which have subsequently resulted in spiralling business failures, home possessions and job layoffs.

A much more sensible approach is to do the opposite: to underfund the government deficit and thereby boost the public sector contribution to the broad money supply to provide additional cash-flow for embattled companies and consumers.

Conclusion

If there were any doubt concerning the severity of our economic situation, the events following the bankruptcy of Lehman Brothers last September

have resolved them. The failure of the authorities, here and abroad, to address the credit crisis head-on in timely fashion has magnified its impact on the real economy and its likely duration. However, in forcing the private sector to make an abrupt adjustment to its aggregate spending, rather than a gradual one, we can hope that the agonies of 2008Q4 and 2009Q1 are exceptional.

A progressive monetisation of existing bonds and other debt instruments, and of a fair proportion of government budget deficits over the next couple of years would propel us into a much more inflationary world than we can imagine presently. Many compromises and sacrifices have and will be made to drag our economy out of depression, but we should be confident that this will happen.

2nd February 2009

PERSPECTIVES ON THE ECONOMIC CRISIS

Past: Economic Cycles – by Peter L. Griffiths

It is possible to trace the historical origins of the present financial crisis. In 1977 while Jimmy Carter was President of the USA, the Federal Act CRA was passed. This stands for Community Reinvestment Act, and it authorised political pressure to be exerted on banks particularly affecting their lending policy. This meant that political pressure could be exerted on banks to lend to poor families to buy their own homes without much prospect of the advance being repaid particularly if house prices fell. Bill Clinton introduced amendments to the CRA to establish a system of bank ratings favouring advances made to families living in poor neighbourhoods. In response to the setting up of Federal enforcement offices, mortgage banks from the middle 1990s relaxed their lending standards, and from 1994 to 1999 home ownership increased substantially. At the same time Clinton's government pressed Fannie Mae and Freddie Mac, the two Government Sponsored Enterprises engaged in the secondary mortgage market, to expand mortgage loans among low and moderate earners. New rules were

introduced permitting the securitisation of subprime loans, which mostly replaced mortgages originating 10–12 years previously.

A result of this was that in July 2008 there was public perception of looming insolvency. However it was expected that the United States government would extend the guarantees of capital despite doubts about the legal position. The law underlying Government Sponsored Enterprises including Fannie Mae and Freddie Mac clearly stipulated that securities held by GSEs are not protected by the United States Government. Nevertheless there was widespread belief that the US Government would prevent a disastrous default. This however proved to be illusory. On September 8 2008 FHFA Director James B. Lockhart III announced that he had put Fannie Mae and Freddie Mac under the conservatorship (in English English this roughly means receivership) of the FHFA. This effectively prevented Fannie Mae and Freddie Mac from carrying out their legal duties of guaranteeing subprime loans (with certain interesting exceptions such as loans held by the Asian Central Banks; the Asian tiger economies seemed to be dependent on Fannie Mae and the United States Government after all). The financial failure of Government Sponsored Enterprises was clearly a warning sign for private sector institutions engaged in similar economic activities, particularly the US investment banks which had been permitted to increase their indebtedness by a ruling of the Securities and Exchange Commission issued in 2004. Consequently, later in September 2008 several of the leading US investment banks either became bankrupt or were taken over by other banks.

Meanwhile this financial crisis was compounded by British Acts of Parliament. The Building Societies Act 1986 relaxed the rules governing building societies. This clearly led to the insolvency of Northern Rock in February 2008. The Local Government and Housing Act of 1989 originated a statutory instrument which established a new capital finance system for local authorities as from 1 April 1990, which enabled local authorities to make deposits in authorised institutions as defined by the Banking Act 1987. In May 1997 the newly elected Labour Government announced its intention to introduce substantial reforms to the regulation of the UK financial services generally. This produced a quango – Financial Services Authority, whose statutory status was confirmed by the Financial Services and Markets Act 2000. The Financial Services Authority had already been issuing press releases since May 1999 giving notice of amending the list of authorised institutions defined by the Banking Act 1987. An interesting example of an addition to the list was the Icelandic Investment Bank.

In answer to the question in the title, the present economic cycle has been generated by the delayed consequences of legislation applied to credit.

Since laws removing credit controls on both sides of the Atlantic have been the cause of the present deflation, one obvious remedy which suggests itself is the restoration of these controls so that there will be a greater likelihood of new borrowers being able to repay their debts. This will unfortunately still discriminate against poor families but the housing of poor families would be better provided through the social security system rather than through 'influencing' the banking system or through the tax system.

Present: Gloom – by Damon de Laszlo

It is worth remembering that the Western economic bubble plateaued in 2007 and I was expecting it to deflate in 2008. Unfortunately the economy in general continued to grow in 2008 and instead of deflating it burst in September/October with the total collapse of the banking system. To mix metaphors, the tide went out very suddenly leaving the banks, the private equity magicians, the hedge fund managers and financial markets in general, naked. The total breakdown of the banking system around the world brought global trade and industry to a juddering halt.

The mountains of debt that fuelled the Western economies for the last five years collapsed, leaving a black hole in the world's financial system. We now have the rapid appearance of deflation taking hold around the world. Prices and wages are being forced down and debt is being repaid or written off. On the other side of the balance sheet, asset values are being destroyed which in turn is wiping out people's savings and pension schemes. This downward spiral will at some point stop, probably as suddenly as it appeared, but the global economy is in uncharted waters.

Around the world the Central Authorities are reacting in different ways depending on each country's individual economic profile. The US started by throwing liquidity into the system but is now focussing on the real problem, dealing with a credit crisis. It is interesting that Treasury Bill rates have gone to zero or minus interest rates, that is lower than during the Depression of the 1930s. This coupled with the underwriting of the banking system will force the trillions of dollars in Money Market funds to place money back in the banking system. It is worth noting that the Government is effectively borrowing money at a minus interest rate and lending it out at 4 or 5% to the banks, making a huge profit in the process. As I mentioned, there are

mountains of debt that have to be repaid or literally written off. In the early '80s bank crisis, this was called Debt destruction.

On the other side of the world China, recovering from the Olympic Games and the industrial shutdown, as well as a massive earthquake, is grappling with the fact that a large percentage of its economic growth was export driven. The Chinese economy, which suffers from both the advantages and disadvantages of central planning, has to reverse its direction, from exporting consumer goods to internal consumption. It has the Central Government controls to do this as well as the reserves. The Chinese Government stimulus package, broken down roughly, is allocated 45% to railways, roads and airports; 25% to the earthquake recovery areas; 9% to rural infrastructure; 9% to energy efficiency and environment; 7% to low income housing and 4% to technology and R&D. This augers well for China's future growth.

By contrast, the UK's reaction to the problem, apart from the necessary support for the banking system, was the announcement to bring forward infrastructure expenditure, which is unlikely to happen as they simultaneously announced the postponement of major industrial military expenditure on aircraft carriers and in any case most infrastructure projects are stalled in interminable planning enquiries and debates, e.g. runways at London Airport and Stansted. Along with this, a VAT reduction that will cost the Government billions and have no commercial impact apart from the huge bureaucratic burden it lays across industrial inter-company prices. In any event, private individuals should sensibly be paying down debt rather than being encouraged to spend. The UK Government debt going into the coming year of some £145bn. is unlikely to be fundable and can only lead in due course to rising interest rates and devaluation. Not a recipe for an industrial renaissance.

Germany by contrast, has a less hysterical Government that is watching its banking system carefully and will probably support, where required, its industry so as to get the country on to a sustainable recovery path.

While there are many, many anomalies and dangers in the fabric of the world's economic systems, I take an optimistic view, rightly or wrongly, as an entrepreneur has to deal with risk all the time and risk-taking is not compatible with pessimism. However, I am having a struggle remaining convinced that we will be over the worst by the 3rd/4th quarter of 2009. Unless the banking system unglues itself very soon, the global network of interrelated industrial companies that support our modern lifestyle will start to break. Repairing the extraordinarily complex computer controlled

industrial networks will take time and will add to the inflationary pressures that are being built into the system at the moment.

Future: The Holy Grail – by Richard Koo

The Holy Grail of Macro Economics: Lessons from Japan's great recession.
Richard C. Koo, Pub. Wiley 2008

Many books about Japan's economy hold little interest for those of us concerned with problems here. But this is the exception - it might well be the answer to George Osbourne's prayer. And it is entirely readable - good straightforward English, virtually no equations but a modest number of graphs and charts. Richard Koo, Chief Economist of Nomura Research Institute, sets out to answer four questions:

i) What has been the dominant economic problem underlying Japan's economic recession 1990–2008?
ii) Are there similarities between this recession and America's 1929–35 experience?
iii) What needs to be added to our understanding of macro-economics?
iv) Can Japan's experience help us through our own credit crunch and it's aftermath?

Japan's economic recession 1990–2008

The 'story so far' of the explanations for Japan's long recession is an interesting one. After the asset price bubble of the 1980s was 'pricked' by a Bank of Japan interest rise, growth rates slumped. After a while interest rates were brought down to near zero but asset prices continued to fall. Only government deficit spending prevented falls in real National Income. Retail price inflation, which had been very small during the 1980s has been on the brink of deflation ever since, but Japan has chosen to bequeath to future generations a huge Government debt rather than a broken economy.

Most of the early 'explanations' for lost dynamism centred on 'structural' issues. American economics professor Michael Porter argued that many Japanese companies, having been sheltered from competitive pressures by government policies, were simply following poor corporate strategies thus wasting assets. Cambridge economist Bai Gao argued that the lack

of government welfare (especially pension) provision in Japan means that companies shoulder this responsibility for their employees resulting in the appearance of labour hoarding, inflexibility and thus a poor allocation of Japan's talented and hard working labour resources. Then there came the 'wrong people in charge' explanations. Jon Snow, in a 2001 TV documentary concluded that Japan's leaders, corporate, local authority and in the central government, were all 'old men' who had long since lost the passion for change whilst Karel van Wolferen had earlier argued that there is a vacuum at the heart of Japanese politics. There was, he complained, no Maggy Thatcher to take a strong lead in sorting out problems and giving a new direction. Meanwhile, macro economists including America's Paul Krugman and in London Anatole Koletski began to notice that the level of Japanese total nominal savings were exceeding corporate investment and urged the Japanese government to 'reflate' through massive and repeated deficit financing which it did though it seemed, always too little, too late and involving too much pork-barrel politics in the choice of expenditure projects.

Meanwhile, the 'structural' explainers were by no means ready to accept defeat. Richard Katz wrote two excellent books arguing that large established Japanese companies make, in their home market, high profits (restrictive marketing conditions enable them to charge higher prices, weak labour unionisation enables them to resist wage increase demands, subcontractors can easily be forced to accept very low payments etc), and, because the 'market for corporate control' barely functions, companies can excessively retain earnings rather than pay out dividends (the price of shares and the dividend income of shareholders, including pension funds, can be largely ignored) and so *company savings* explain Japan's 'excess savings' problem and the solution lies not in government deficit spending but in opening up competitive pressures so that lower prices, higher wages and higher dividends erode 'retained earnings' forcing companies to use the *people's savings* via bank lending etc. Recent research by Keio economist Atsushi Maki has confirmed that changes in both consumption and savings both before and after 1990 largely took place within the business sector. Household saving and consumption behaviour has been remarkably stable.

Given this history, what has Richard Koo to add? His starting point is his many often confidential conversations with Japanese company CEOs during the past 15 years. What emerges is that, largely undeclared, vast deficits appeared in company balance sheets as the assets – land, buildings, and shares: in other companies they owned, sank dramatically in value whilst

their borrowings (and in the post war period, at least up to 1990, Japanese companies were notably highly geared) were still outstanding. In principle, despite having strong daily cash flow positions and profitable business activities, they were in trouble. The balance sheet, honestly interpreted, showed liabilities exceeding assets. They were bankrupt! Reacting to this situation, and with their survival and managerial autonomy at stake, their priority objective changed from maximising profits to minimising debt. New production and expansion was curtailed and all available funds went towards paying off debts – even though borrowings from banks carried super low interest rates. Koo would agree with both Katz and Maki that it was corporate, not household, savings that increased during the 1990s. The difference is that whilst Katz saw this as the result of structural anti-competitive problems, Koo identifies it as a necessity of corporate (or at least corporate management) survival.

Koo goes further. If total savings have exceeded total investment over a sustained period because companies are restoring the health of their balance sheets, then this should be described as a 'Balance Sheet Recession' and we are asked to note that no other post-war recession is of this kind. Thus the dominant problem is the effects of a bursting asset bubble – and it is a once-in-a-generation affair. All the other explanations have merit, but they are not the key.

The similarities between Japan's great recession and America's great depression

A fair chunk of this book is devoted to drawing parallels between recent Japanese experience and America's pre-war trauma. Federal Reserve's Ben Bernanke has made his major research topic the 1929–1935 experience – but has yet to identify it as another example of a 'balance sheet recession/ depression'. Current conventional wisdom holds that the American Great Depression was caused by monetary mismanagement after the share price crash of 1929 and that recovery came with the New Deal expenditures. Koo points out that, as in recent Japan, interest rates fell to low levels and, again as in Japan, the real reason why banks did not lend as much as the economy needed to lend was because companies were not borrowing even though bankers were willing to lend. We have been led to believe that the problem was the *supply* of bank money whilst in fact the problem was the *demand* for loans. Studies of interest rate differentials and surveys asking business how accommodating their bankers are to their requests provide evidence for this. Koo claims that we can now fully explain both events.

Our new understanding of macro-economics

All economics, both micro and macro, has been based on the belief that, at least as a workable simplification, firms seek to maximise profits. All models and explanations - liquidity traps, marginal propensities, IS/LM interactions, market analysis for capital, labour and goods etc work on this assumption. *But if, once in a blue moon, and for an extended period, firms are forced to switch priority from maximising profits to minimising debts, everything changes*. This is fear rather than greed. We need fiscal stimulus not just as 'pump-priming' but as a longer term pillar of the economy until 'normality' is resumed and business regains those 'animal spirits' of optimism and expansion.

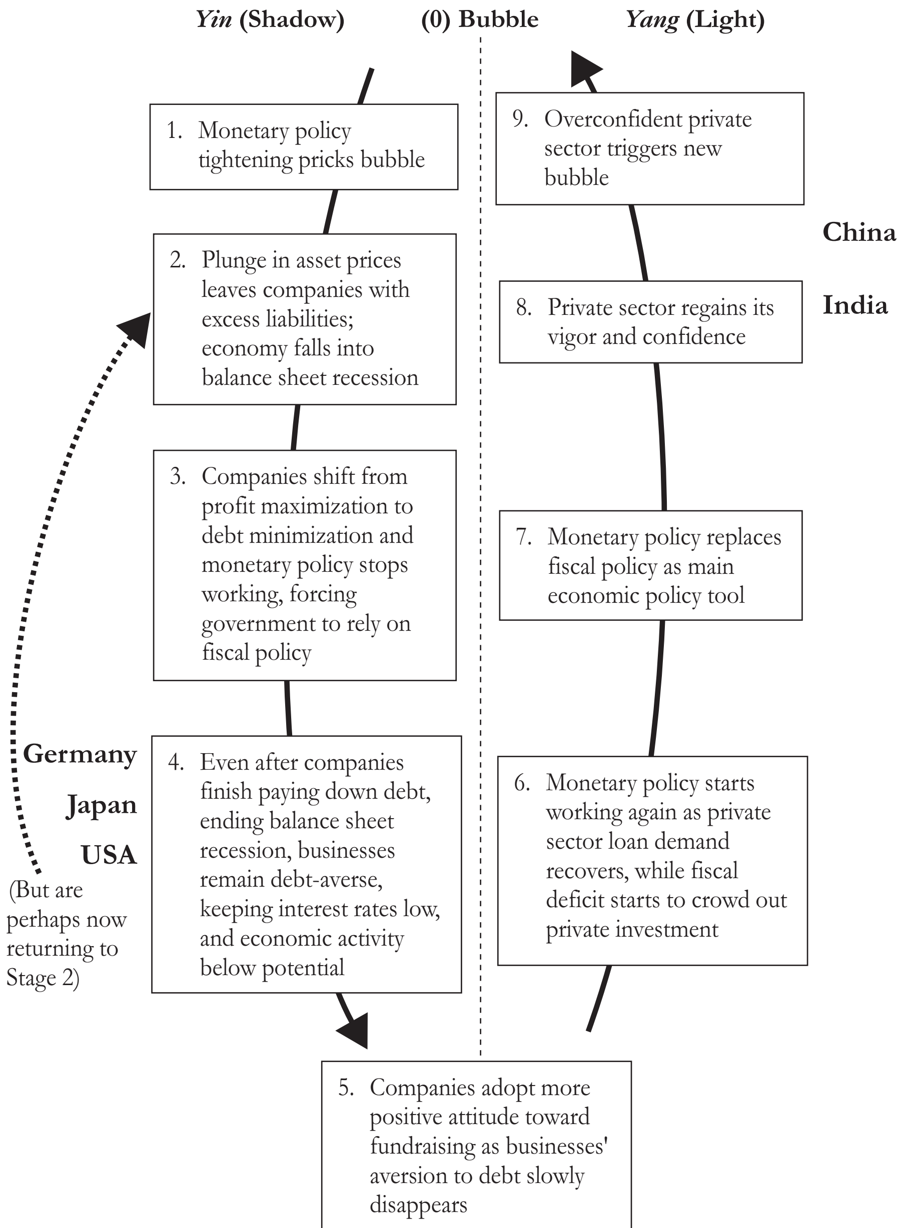
Rather in the manner of 1920's Russian economist Nikolai Kondratieff's 'long wave' theory, Koo then develops his 'Yin-Yang cycle of bubbles and balance sheet recessions'. During the 'Yang' (Light) phase confidence grows, expansion takes place and assets grow in value but, after an asset bubble, the 'Yin' (Shadow) phase begins during which companies learn the lesson that they should not allow themselves to be vulnerable through over-borrowing and the overall economy depends heavily on fiscal expansion. Keynes used tools appropriate to the 'Yang' phase to try and explain the 'Yin' phase. Now we are in a position to correct his work. This really is challenging stuff:

So can Japan's experience help us today?

Certainly an increase in our understanding of the 1929-35 depression is welcome and one can see that there are great similarities between Japan now and America then – to start with, both were characterised by corporate borrowing being far greater than private loans. In both cases, it was the behaviour of companies rather than individuals, that dominated. But today in Britain and America, the private mortgage market is huge and so we are equally concerned with individual behaviour. Will individuals change from profit maximising (endlessly striving to improve their lifestyle) to debt minimising (living like church mice until debts are paid off)? Maybe.

But we are not quite 'there' yet. Asset prices in Britain and America rose during the past 10 years to record highs, perhaps we could say to double their true worth but asset prices in 1980s Japan went wildly beyond this. Today's 'realistic' Nikkei index stands at around 8000 but in 1990 reached five times that level, as did land and house values. Not that many people, and not that many British firms are so highly geared that striving to maximise

The *Yin-Yang* Cycle of Bubbles and Balance Sheet Recesions



A New ‘General Theory’ of Macroeconomics

	Yang	*Yin*
1) Phenomenon	Textbook economy	Balance sheet recession
2) Fundamental driver	Adam Smith's ‘invisible hand’	Fallacy of composition
3) Corporate financial condition	Assets > Liabilities	Assets < Liabilities
4) Behavioral principle	Profit maximization	Debt minimization
5) Outcome	Greatest good for greatest number	Depression if left unattended
6) Monetary policy	Effective	Ineffective (liquidity trap)
7) Fiscal policy	Counterproductive (crowding-out)	Effective
8) Prices	Inflation	Deflation
9) Interest rates	Normal	Very low
10 Savings	Virtue	Vice (paradox of thrift)
11) Remedy for Banking Crisis	‘Fat spread’ and quick disposal of NPLs	Capital injection and cautious disposal of NPLs

future benefits need be abandoned. We have yet to exhaust the armoury in ‘getting the banks lending normally again’.

All the same, we should recognise that Japan, given the huge loss of national wealth which asset price falls created, and the ease with which Japan could have slipped into the trap of depression, has done rather well in pursuing policies which have kept real National Income steady, maintained a prosperous country without very much unemployment and ‘held its nerve’ so that now that companies have at last cleaned up their balance sheets, net private sector borrowing is taking place and companies are beginning to expand their operations. This has been an unsung triumph - the avoidance of calamity. If we in Britain are now to be tested, will we do as well?

J.B.

Note. Full references for all names given in this review are available on request.

WHEN WILL WE SEE 'PEAK' OIL PRODUCTION?

On the 14th October 2008 the All Party Parliamentary Group on Peak Oil and Gas, in conjunction with the Economic Research Council held a panel discussion in the Palace of Westminster. Some very brief observer's notes give an indication of some of the points made.

Dr Richard Pike from the Royal Society of Chemistry pointed to the various categories of oil reserves such as 'proven', 'probable', 'possible' and 'undiscovered' noting that only 'proven' reserves normally come out in public discussion and, because these are based on oil companies' declaration, are an incomplete picture grossly underestimating what is really there. In fact whilst figures for 'proven reserves' commonly claim that there is 40 years' supply left, the true amount is more likely to be 80 years. 'There is very much more there than we have been led to believe' he said before adding that the true constraints lie in the facilities installed which are subject to economic and environmental balance.

Jeremy Nicholson from the Energy Intensive Users Group began by adding to Dr Pike's observations the fact that there have been numerous examples of false dawns on peak oil of the past century – each of which has been quickly disproved. He then pointed towards other factors which should enable us to be more optimistic. Firstly, that innovation should not be underestimated – new ways are constantly being found. Secondly, we are developing new sources of energy which can reduce our need for oil. Thirdly, we are developing energy efficiency impressively and fourthly, many countries such as Denmark, Israel, Japan and Sweden are already several years past their peak oil consumption.

Tim Guinness Energy Fund Manager felt that the first two speakers had painted an 'over-rosy picture'. His estimate is that the world originally contained 4 to 5 trillion barrels of reasonably accessible oil. So far we have used 1.2 trillion barrels and we have a further 1.4 trillion barrels of 'proven' reserves. So, given that we are using about 280 billion barrels per year at present, peak oil will occur in 25 to 45 years' time. On individual countries he noted that the United States peaked in 1970 and the UK peaked in 1998. The answer for the future, he said was nuclear, renewables and oil for some things.

Chris Skrebowski of the Petroleum Review briefly hinted that Peak Oil would be a frighteningly short time ahead but concentrated on a much shorter time analysis. He looked at the rate of discovery and the rate of

consumption and he gloomily predicted that the recession would lead to cutbacks in development – deep sea oil projects postponed, cutbacks in tar sands development, a slippage in general infrastructure investment etc curtailing supply growth. Oil prices would therefore be on an upward trajectory and diesel prices would rise fastest because 'the easiest way to quickly install electricity supply in poorer places is to buy a diesel generator'. He pointed out that 55% of oil is used for surface transport, 10% for heating, 10% for special products such as solvents and 25% for jet fuel and shipping. The only way to 'get out of the hole' on oil shortage is therefore to get away from using oil for surface transport.

Dr Michael Smith of Energy Miles said that 'complacency was not justified' there are 'below ground' limitations as well. Oil fields reach a peak of output and already some 50 countries have passed this point. He said that he saw a flattening of output in 'less than a decade' and it would be foolish self-deception to think that we should do anything other than set about conservation programs to 'reduce our vulnerability'.

And a conclusion? Not really except to note that those closest to the oil industry are more alarmist whilst those of a more academic frame of mind seem more hopeful. And during the Q&A session it was intriguingly suggested that we may pass Peak Oil due to lower demand and not geological constraints – as happened to horse transport, coal and steam engines …

(Available on line www.appgopo.org.uk)

So what have we learned in 2 millennia?

"The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance." *Cicero - 55 BC*

.... Evidently nothing.

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

SIGNATURE OF PROPOSER..