BRITAIN & OVERSEAS

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

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THE LONG AND THE SHORT OF IT

*A talk given by John Kay, one of Britain's leading economists, to members of the Economic Research Council on Wednesday 18th March 2009**

I am going to talk tonight about finance, about what has happened, about what we should do politically in response, and what we should do as individuals.

What has happened?

First of all, what has happened, what is the cause of our present troubles? I want to begin by saying that they are not caused by the housing bubble in the United States; they are caused by sub-prime mortgages in America only in roughly the same sense as the First World War was caused by the assassination of Archduke Franz Ferdinand, and they are not caused either by the inclination of people in the Anglo-American world to borrow too much and to spend rather cavalierly on credit; basically the cause of our present crisis is unsuccessful speculative trading by large banks in wholesale money markets. And I want to say that that is the centre of it and I want to say that as often as I have the opportunity to say so.

In a sense, if we are looking for deeper causes, I think one can go back and say they are to be found in over-expansion of the financial services in the 1980s and 1990s and through the global balance of the world economy which was set in place by the end of that period, but really the roots of our present crisis can be found in the bursting of the new economy bubble back in 2000. We essentially postponed the day of reckoning for several years as a result of the policy actions which were taken then, but postponed them only at the expense, as we know now, of making the ultimate crisis quite a lot worse.

But the experience in my personal life that gave me most insight into this present crisis as it was developing and as it has now evolved, was the experience I had when I got involved in the early 1990s in the process of reform and reconstruction as it was called, in the Lloyds insurance market. Now, some of you may know a little bit about (some of you may

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* 'The long and the short of it, finance and investment for normally intelligent people who are not in the industry' by John Kay is published by The Erasmus Press 2009, price £11.99

know rather more than you want to know) about what went on in Lloyds in the course of the 1980s. Lloyds was always primarily only an insurance market in which people insured the amount over a certain amount of losses on particular policies. What happened in Lloyds was that people created re-insurance of re-insurance, and you could re-insure, it was possible for a syndicate to re-insure the total amount of its losses, and it became possible for individuals to re-insure the total amount of an individual's losses. And as these re-insurance contracts were written, it then became possible for syndicates to write, not just re-insurance contracts of these types, but re-insurance for syndicates that had taken on a batch of these re-insurance contracts, and it then became possible to re-insure these contracts as well. And the result of that of course was that, after you had been through two or three layers of contracts of this kind, it became impossible, even if you wanted to try, to draw down through the layers of insurance and re-insurance and discover what the underlying risk structure actually was. Now all that started to come unstuck in 1987 when an oil rig called Piper Alpha went on fire in the North Sea, and that rig was destroyed with the loss of nearly 200 lives, and was at the time the largest single claim that had ever been made against the Lloyds insurance market. Of course what that did was to trigger a lot of re-insurance contracts, and that of course triggered another layer of re-insurance contracts, and that triggered even more re-insurance contracts, and so on, and the losses spiralled round the market in this kind of way until in the end an initial claim by Occidental of $1 billion added up to total claims of $16 billion in the Lloyds market. And what emerged when all that settled down, so far as it ever did settle down, is that people who had never heard of Piper Alpha discovered that they had re-insured it, and re-insured it, not just once, but re-insured it over and over and over again. And one of the great insights of that experience for me was not merely realising the degree to which this process had been generated by people who had been deriving fees and commissions on these contracts at every stage, not just the discovery of what had started off as a process of sharing risk around the market, had ended up as a process of concentrating it. But I spent an afternoon with a group of Lloyds insurance brokers and I must say, having spent a fair part of my life in the academic world and some of it in other parts of the financial services sector with investment bankers, I thought I knew a lot about arrogant people and had a lot of experience of arrogant people, but I must say smart Lloyds underwriters are just about the most arrogant people I have ever encountered anywhere in my life. And these people were denouncing the people who had imposed so much damage on the market, and I asked them, well if these people were so stupid, why didn't you blow the whistle? And the answer they gave to me with a degree of incredulity was to say that these people were buying risks from them at prices at which they were very happy to sell them. What was happening in these markets was that people who knew a little bit about the risks they were taking on were dumping these risks on people who understood less. And that is how the final outcome was that these risks were actually concentrated on people who knew and understood nothing about them at all. And that was how, as we all know, some of the stately homes of England in the end had to be sold up in order to meet the losses that their proprietors had incurred on the Lloyds insurance market.

That was an experience which was valuable to me in watching what went on in financial markets after 2003 because, you will recall, if you go back to banks as they were in the 1960s and 1970s, they were the type of boring institutions which were immortalised in films like Mary Poppins. What banks did was they took in deposits and they took the money and they made loans with it. All that started to change when, as a result of a combination of globalization and deregulation, we got the formation of financial conglomerates and while there had always been wholesale money markets because some banks were better at taking deposits and other banks were better at making loans, these wholesale deposit markets started to grow at a rate that far exceeded the rates of the underlying deposits. Just as in Lloyds, the total volume of insurance contracts started to grow far faster than the level of the underlying business. Banks created securitisation in which they could package parcels of loans and sell them on to other institutions, who were mostly in fact banks, and in a way that was very familiar from the way I described, having taken a package of loans, you could split up the loans into different components, you could then package them up again into new loans, you could construct packages of packages of loans, and ultimately you could construct ever more complicated instruments with different proposed risk characteristics, on the basis of these underlying packages. But of course nothing you could do in these packages would make the underlying lenders pay a penny more or a penny less.

If that process was going to unwind in Lloyds and the trigger for the unwinding was Piper Alpha, in a similar way, the trigger for the unwinding in wholesale financial markets was losses in sub-prime mortgages in early 2007. That triggered people to ask the question, what is actually in the packages which we have been buying and selling and, once you have created doubts about the value of these packages, that created doubts about the value of other securities based on them, that created doubts about the value of other assets on banks' balance sheets, and ultimately that created doubts about the value of assets generated by the banks themselves. So the whole process of the unwinding of the packages and repackaging which had gone on was reproduced in this set of events and has led us ultimately to the situation in which we now find ourselves, in which the only way of supporting the continuation of the global banking system is essentially for governments to underwrite the liabilities of a range of major banks.

What should we do politically in response?

So what should that mean for us in our role as concerned citizens? What should we do in policy terms going forward? What I have described is a situation in which we have attached a casino essentially to a utility. We have in the payments system, in the banking system that we need in order to meet our ordinary day-to-day requirements of making deposits, paying bills, receiving our salaries, and in the ordinary consumer and mortgage lending and small/medium-sized business lending, we have a utility business that essentially serves the same economic role, or the same necessary kind of economic role, as do the basic utilities of our transport system, our electricity system, and our water system. It is because we can't do without these utilities, even for a short time, that we have to be prepared to intervene to protect these utilities in the event of the financial failure of the organisations that provide them. But by essentially attaching the casino of this wholesale investment banking activity to our retail banking activities, we have enabled these conglomerate banks to put us in the position that the only way we can preserve the utility on that day-to-day basis is actually to underwrite not just the utility activities but the casino activities. And if one describes the problem in this way, there are two ways we can prevent it developing and recurring. One is that we can regulate the wholesale activities of the banks in such a way that we can be confident that these kinds of problems will never recur, that is we can regulate the gamblers in the casino so that they can never lose enough money in the casino to jeopardise the operation of the associated utility. If you think it is realistic in the face of the kind of political clout that these bankers have and their ability to evade the kind of formal regulation which has been imposed on them historically, if you believe that that road is likely to succeed, you have expectations about the potential for regulation that I believe are far in excess of what is reasonable and certainly far in excess of our historic experience of regulation.

I am quite clear that the better approach is to separate the utility from the casino, to have a relatively tightly regulated narrow banking sector that is governed by a mixture of legal limitations on the things these banks can engage in, a mixture of rather extensive reserve requirements of the kinds which indeed there were historically, and probably an insistence on giving the retail depositors of the institutions priority in the event of liquidation, that is to restrict the activities of the people who operate the utility to utility operations, and then I would see relatively modest regulation of the remaining wholesale activities of the financial market, that is we should get out of the business of believing that we can regulate to create financial stability, and particularly get out of the business of saying we can engage in wholesale prudential supervision of the activities of all financial institutions.

What should we do as individuals?

Let me now say a little bit about the third of my questions – what you should do about these things as individuals which, as I say, is the larger part of what I have to say in the book.

The obvious question which anyone must ask themselves, and many people are asking themselves in light of what has happened in global financial markets over the last couple of years, is that, if these people are so bad at managing their own money, why on earth should I trust them to manage mine? And that really provides the starting point for, where I developed the strategy for the book from, which is to say that people actually have to take a lot more control of their own financial affairs.

The first lesson that follows from that is to say that the surest way of increasing, the surest and least risky way of increasing the return on your investments is to pay less to the people in the financial services industry. I have illustrated that with a calculation whose result still takes my breath away, which was to take the world's most successful investor, Warren Buffett, and ask, suppose he has – the way Buffett would run his clients is that he is an investor and is essentially on terms identical, that he invested on terms identical with those of other people – suppose instead he charged himself for managing his money, and I put up the hypothesis, not that he charged other people for managing their money, but that he simply charged himself for managing his own money. I asked the question, if one took

Buffett's wealth of a year ago, $62 billion, how much of that would belong to Warren Buffett and how much of it would belong to Buffett Investment Management? The answer is that Warren Buffett would have $5 billion of the $62 billion, and Buffett Investment Management, charging the standard hedge fund rates, would have accumulated a total of $57 billion over the period. There is no more forceful way I think of illustrating either the power of compound interest operating over a period of forty years, or of illustrating why it is that the financial services sector has become so profitable and that a lot of people who have entrusted their funds have not profited in quite the same way or to quite the same extent. The first lesson therefore is that the surest way to increase the returns on your investment is to pay less to people in financial services.

The second lesson is the degree to which the people in the financial services industry are bound by the conventional wisdom of the time, and if that was true in the new economy bubble of 1998–2000, it was true of securitisation mania from 2003 to 2007. However stupid what people are doing in the industry is, there is almost irresistible pressure for them all to do similar things at the same time, and it is very difficult even for people who have doubts about the validity of these propositions to stand out against that particular trend. In other words, the investor who is outside the financial services industry actually has a positive advantage by not being part of that conventional wisdom. That is the mechanism to stay out of these particular manias, just an ordinary scepticism about that conventional wisdom combined with an overriding principle of, if you don't understand it, it's probably not a very good idea to get involved in it – a principle which would have served not only small investors but very large professional investors rather well, particularly over the last five years.

So the basic principle of personal investment is to be contrarian, not to be perverse, but simply to be resistant to the conventional wisdom, whatever it may be at the time.

Following these two principles, many people have taken the view that what you ought to do is simply index the money you invest. There is something to be said for that, it certainly meets the principle of pay less and contrarianism, but actually simply indexing gives you what is a remarkably undiversified portfolio. Even when I was putting the finishing touches to writing my book it was still true that a portfolio which was indexed would have been rather heavily concentrated in oil companies, telecommunications, pharmaceuticals, and above all financial services, which in mid-2007 actually accounted for over 30% of the UK index – well it doesn't account for 30%

of the UK index any more! What you have in that portfolio is actually not particularly diversified.

So what I talk about in the book is the way in which people can build for themselves a genuinely diversified portfolio, and I start with the argument that the simplest strategy for the individual taking control of his/her own finances to adopt is that we can mimic what it is that the average well-advised professional investor does. And you can easily find out what, for example, the model portfolio for the average UK pension fund is and follow that, and since that is all a professional adviser will physically do for you anyway, you can do that for yourself and you can save the fees that the professional adviser would take for implementing that particular portfolio for you. That's something that the intelligent investor with a home computer can actually now do in less than an hour because one of the things which I hadn't realised fully the extent of, when I started writing, was the degree to which a mixture of the internet and financial innovation, but particularly the internet, had transformed the opportunities available for individual investors to get access to products and obtain information in a way that would have been unimaginable even a decade ago. And that's what has created the situation where an individual investor who doesn't really want to get involved in taking individual investment decisions on his/her own behalf, can replicate one of these model investment portfolios with half an hour to an hour of time on a home computer, and create a portfolio that, because it mimics the average of professional investors' investment portfolios doesn't have to be worried about for a very long time. People don't have to invest a lot of time any more to manage their own investments, but actually by starting from there and following over time the principles of being resistant to conventional wisdom, being contrarian and diversifying more than the professional average, professional portfolio actually does, you can have realistic prospects of doing better over time than that average professional investor.

So we don't have to pay the fees which these people have extracted any more in order to do as well or even better than these people will do for you. We now have the opportunity to put our investments in the only hands that events have shown you can confidently trust, which are your own.

AN ECONOMIC COMMENTARY*

By Lord Vinson

Lord Keynes was addressing a group of bankers and asked them to raise their hand if they had ever printed more notes than their gold represented. A forest of hands went up. Keynes foresaw that there are times, like the present economic crisis, when Governments have no alternative but to create artificial wealth to replace at least some of the overvalued wealth that created the problem in the first place.

Concurrently it is an excellent thing that we are not in the euro. This enables us to do what we want to do to the benefit of our economy. In a paper-currency world, money is credit and credit is money. Credit is given on the assumption that its value and more will be recovered. I am sure your Lordships are aware that when a bank raises £1 billion in capital, it is in a position to lend £10 billion worth of credit, and does, on the assumption that it will not all be called for at the same time and it is confident that the risk is spread. The key word is 'confidence' and the gearing effect of credit relies on confidence.

Conversely, if the collateral that underpinned that credit decision suddenly disappears, we have a situation, like today, where the ungearing is dramatic and liquidity, the life blood of economic activity, is massively drained from the system. We witness a colossal reduction of credit, due not only to the sub-prime losses of the worldwide overvaluation of property but also the destruction of collateral consequent to the collapse of share prices – a double whammy of a self-feeding collapse in confidence.

Under these circumstances, it is perfectly right and proper to put back by quantitative easing, or 'printing money' – call it what you will – the essential life blood of liquidity to prevent the patient from haemorrhaging to death. The velocity of circulation, the heartbeat of the patient, has to be kept going. Professor Milton Friedman, the arch-monetarist whom I had the privilege of meeting, suggested using aircraft to sprinkle the country with bucket loads of notes. The concept of printing money is abhorrent but 10 years of deflation would be far worse, as the great slumps of the 1920s and 1930s showed.

In the 18th century, in an effort to cure the patient's malady, doctors

* House of Lords 27/01/09. Lord Vinson was chairman of the board of the Institute of Economic Affairs 1988–1995

got it all wrong by bleeding a person already haemorrhaging. This is not the time to make the situation worse by cutting back, other than by the elimination of waste. It is the time for pumping liquidity back into the system, the art being to recognise that, as the economy recovers, interest rates will need to be raised in good time to prevent the patient overheating. National Governments are understandably afraid of doing this in case the international finger of scorn is pointed at them, and we have partly, witnessed this by a run on the pound. However, if it is done on a global scale, as Keynes broadly suggested, everyone is in the same boat. We should reflate simultaneously with the EU, but that is unlikely.

To update Keynes's concept, the group of 20, shortly to meet, should authorise the IMF to issue loans to member countries of up to 5, 6 or 7 per cent of their GNP. Such loans could carry 2 per cent interest over 30 years. These, in turn, would be lent on by national Treasuries to their own banks, enabling them to lend at, say, 4 per cent interest to their clients. Anyone who cannot afford to borrow at 4 per cent or thereabouts should not borrow at all. Today, as has been well said, it is not the cost of money that is the problem but the lack of it.

Using such a system, over 30 years the principal will have been repaid as interest and the IMF could quietly write off the loan in the same manner as it currently writes off loans to third world countries. Either way, it is essential to print money at this stage and it is excellent to see that Mr Ben Bernanke is pursuing this line in the United States. We should follow in unison with others. Like the USA, we should be putting money into infrastructure improvements, most of which would be of long-term economic benefit. It was crazy to cancel the aircraft carrier orders at this stage, and expenditure on desperately needed road repairs would have an immediate beneficial effect.

Economic fashions come and go, and very few look watertight 10 years after they are implemented. One should be humble with any prognosis. As Keynes said, one should pronounce on economic matters with a contrite heart. However, the current concept that we have to reduce interest rates to near zero is a complete fallacy. The unintended consequences of so doing will in fact negate any possible benefit, as low interest rates in Japan over a decade clearly illustrated. That did not lead to Japan's recovery; it led, partly through the financial 'carry trade', to cheap money for the rest of the world and a virtually stagnant economy in Japan. Consumers are simply not encouraged to spend their life savings if they get no interest on them; they conserve their battered wealth.

There is confusion caused by two contradictory policies: first, a desire for very cheap money to enable the banks to repair their balances; and, secondly, a wish to increase personal consumption, as shown by the Government's VAT cut. But the last thing any Government should do is turn off the expenditure of tens of millions of savers and pensioners who rely on the dividend interest from their savings. It will, of course, also decimate charitable giving, and the work of many charities will cease because they too heavily rely on dividend flow. The concept that we have to have low interest rates to prevent deflation simply does not stand up against the realities of a pound that has depreciated 25 to 30 per cent against the dollar and the euro, and where, before long, our import prices are bound to rise and inflation will be compounded by the reimposition of the VAT that has been cut.

The Shadow Monetary Policy Committee, an august body of academics, thought that interest rates had been cut enough to 2.5 per cent. I hope that the Bank of England and the Treasury between them will reconsider the damaging and unintended consequences of the existing level and further cuts.

I come to the primary purpose of this debate: our financial relationship with Europe. Recent parliamentary Questions have shown that our membership, after all rebates, costs us at least £4 billion a year, apart from the appalling inefficiencies that the ever-growing burden of EU regulations brings to this economy. The French, needless to say, are substantial beneficiaries. Our contribution of £4 billion a year is a lot of money, and many of the rebates we get are for purposes that our own Treasury would not dream of sanctioning. So the real loss to this country, in net terms, is considerably more.

However, this pales into insignificance against the unquantifiable cost of unnecessary regulations, which bring a huge additional burden: it must be tens of billions of pounds a year. To name but four of the culprits, there are the working time directive, the chemicals directive, the height at work directive and the pesticides directive. Now there is even compulsory holiday pay for people who have been on sick leave for up to five years, there is a limit on doctors' working hours, and electronic implants are to be compulsorily put into Britain's 10 million sheep. All these things, like the premature closing down of our coal power stations just when we need them, chisel away and do real economic damage to our flexible economy.

It was not as if we could do anything about it, anything to rectify it in any way. Here, Parliament, through its scrutiny committees, has tried to influence that legislation, but its work has been almost totally ignored. Hundreds of recommendations have been made to improve EU legislation and the hard fact is that our scrutiny committees have been wasting their time. Frustratingly, there is no satisfactory way of rectifying that regulation. This democratic safety valve simply does not work.

Your Lordships will recall that the American War of Independence was triggered on the slogan, 'No taxation without representation'. Today we have the equivalent: 'Regulation without rectification'. Increasingly, our citizens in the front line of business do not like it and we ignore their rumbling discontent at our peril.

Our blind and damaging conformity to EU regulations is like an army marching over the cliff because no one has the courage to question the command. Idealism is a wonderful thing, but blind idealism is damaging this country beyond belief. Day by day and week by week we witness the economy of this country being impoverished by the endless attrition caused by unnecessary EU regulations. Few in Westminster are really aware of what is going on; the political class lives above it all. Eagles seldom know of the habits of moles. I love my country and I hate to see it ruined by bureaucratic nonsenses imposed by non-elected, totally impractical officials.

The denial of the means of rectification is a denial of sovereignty, and without sovereignty democracy cannot exist. We really must re-examine our financial and wider relationships with the EU.

THE CHAIRMAN'S ASSESSMENT

By Damon de Laszlo

Spring has arrived! The flow of events, announcements, actions, conferences and other motions – signifying action – has been a torrent. But the global economic data has relentlessly kept to its downward path and the economic crisis grinds on and fear stalks the lives of millions of people around the world as job losses rise. Furthermore the politicians are becoming complacent and they are also running out of new 'new ideas'.

The world's economies are driving inexorably through the process of adjusting to the bursting of the financial bubble that has given the appearance of prosperity over the last five years. The asset price boom that enabled massive borrowing to take place has been well reported and blamed on those 'greedy bankers', the politicians have as usual avoided blame for their part. It is politicians and Government who failed in their job to manage the regulation and enforce the necessary disciplines in the financial systems of the world. There is much analysis and report on the breakdown of the financial system and much more to come. The question though is how the world's economies will develop going forward.

There seems to be a bifurcation appearing in the world's economy. On one side the USA and China appear to be stabilising, although there is still a lot of historical bad news to be reported, covering the first quarter of 2009 which will roll into the second quarter. By contrast Europe is in a much greater mess and has probably got another three or four quarters of horribly negative growth.

Starting with the USA, the property crash looks as though it is starting to stabilise, the banking system and the Government's actions to support it is beginning to function, industry has de-stocked and the public is starting to save and is repairing its balance sheet. The final problem to be addressed is the disaster called the motor car industry. In China the Government after considerable deliberation is now pouring huge resources into redirecting the economy from being export led towards internal consumption. The process will be painful but it appears to be beginning to work. The process will spill over into the rest of Asia and in all likelihood, we will see stability beginning to appear, albeit at a low or zero growth rate for the time being.

Europe has the greatest structural problems in that it has an extraordinary and novel system of Government. The massive EU bureaucracy is politically unaccountable and basically insensitive to the plight of the constituent countries. Labour laws, environmental rules and gratuitous regulations continue to pour forth hampering the ability of business to adapt to the changing world. Unit labour costs continue to rise inexorably across Europe and the trend will increase as productivity declines draining corporate liquidity. Germany, the main motor of the European economy will continue to contract rapidly as its economic growth from export industries collapses further. Similarly, Britain's economy that has been driven by its financial and property bubble, will continue to deteriorate with the added problem that it will be the first country to experience rising inflation as a result of the depreciation in its currency. UK is also likely to be the country that suffers the biggest Government deficit as a percentage of GDP, owing to the near complete loss of control of Government finance.

The simple problem facing the world is the asymmetric effect of borrowing to finance current expenditure by individuals and the corporate sector, and then repayment of the debt. Profligate lending enabled individuals to borrow money in increasing amounts every year enabling individuals to spend their income plus the extra borrowing. While borrowing is treated as tax free income and spent, its repayment has to be made out of after-tax income, i.e., a dollar or pound that is borrowed and spent costs approximately 1.35 dollars or pounds to repay, before even any interest has been paid. My calculation is obviously a generalisation but it indicates the cause of the huge reduction in retail sales that the indebted economies are having to adjust to. This is before the impact of the rise in unemployment is taken into account.

At the moment there is considerable complacency regarding inflation. De-stocking of the retail and manufacturing sectors produces downward pressure on prices, not only of finished goods but also commodities. As industry adjusts to the lover level of sales, production capacity is reduced. The complex technology and supply chains of modern manufacturing mean that once production has been shut down, it is very difficult to re-start in the short term. For example, the computer systems that run a modern factory are exceedingly difficult to re-start if it is closed, and the technical skills dissipated by redundancies. The same problems apply in the supply of raw materials and commodities. Mines and oil-wells can be closed down relatively quickly, but they take much longer to re-start.

The world going forward is likely in the near future to become inflationary for the reasons described. Added to this, the same Governments that enjoyed the recent boom years will not be averse to a considerable amount of inflation which will help them avoid the consequences of the Government debt that is being piled up.

While these observations predict a shift in the economic paradigm of recent years, it is not a prediction of doom and gloom; it is more the natural ebb and flow of economic trends. Growth and the appearance of prosperity will be more muted in the foreseeable future but that is not necessarily a bad thing …

REDUCING PUBLIC SECTOR WASTE

*A talk give by Sir John Bourn, Chairman of the Professional Oversight Board and former Head of the National Audit Office 1988–2007, to members of the Economic Research Council on Wednesday 18th February 2009**

The subject on which you asked me to focus my remarks is reducing public sector waste, and of course examples of public sector waste are legion. You will remember a few years ago the Dome, estimated to cost £399 million coming in at £625 million, providing an event for a year, without proper planning, without clear ways of how you got there, without considering everything to make it to the event, an event which was launched in the euphoric climate of the millennium, and wasted millions and millions of pounds, though of course we do have a building which after several years another use was found for.

But as well as those mega examples of public waste, another one that some of you may remember from a few years ago was – 'individual learning accounts'. This was a programme to make studying and acquiring skills easier than going to Further Education College or even university. Learning providers would make available straight forward courses and they would, as it were, hunt you down, tell you what the opportunity was. So you might be a housewife in Tesco and someone would come up to you and say 'Good morning, Madam, would you like to know more about computers?' And the surprised housewife might say yes, often said no. In a way you could applaud the idea of trying to make the acquisition of skills straight forward and easy, but this programme was launched without proper consideration of the fact that all sorts of learning providers emerged from the undergrowth without any skill in providing introductions to computers at all. So here was a scheme – that the National Audit Office reported on and common sense showed that it had to be brought to a halt. But £67 million was spent on setting it up and running it for a few months – a scheme which was basically a good idea, but not enough thought had gone into how you actually run it, what sort of people would be learning providers, how would you offset the risk of fraud. So here it was, racing ahead, what a good idea, let's have it tomorrow, and in a sense it was appealing, and as a result of that £67 million – a vast sum of money by ordinary standards – was just thrown away by a failure to think, a failure to work out how we could do

* Partly based on 'Public Sector Auditing: Is it Value for Money' by Sir John Bourn, published 2007 by John Wiley and Sons Ltd

this to make a success of it, because basically it was a 'good idea'. Well, with these examples of waste, what is to be done?

Change the culture

My experience of over fifty years – 20 years as Comptroller and Auditor General and 30 years as a civil servant before that, (so in a sense I am complicit in all the things that I am going to say need to be changed!) – and that of my colleagues has taught me that the whole culture of the Civil Service needs to be changed. I am talking about Central Government here of course; I think many of these points apply to local government and other aspects of public services, but I am talking about Central Government. It is not just my view because the work that Sir Peter Gershon did in his programme for Gateway Reviews which was aimed at spotting problems with big projects early, and if you look at Sir Gus O'Donnell's Departmental Capability Reviews which he has been publishing over the past year or two, there is a recognition both by Peter Gershon and by Gus O'Donnell that performance is diminished, is not as good as it could be, improvements could be made, waste could be reduced, and yet Whitehall still holds back from wholehearted commitment to change that Peter Gershon underlined, that Sir Gus is pushing for.

So what specifically needs to be done? The first thing is to recognise that government is about projects and programmes to meet the needs of the citizens of the United Kingdom. Projects and programmes are not simply civil engineering projects and programmes, but a new system of taxation, a new system of social welfare, those are projects too. Government is about the evolution and implementation of programmes and projects. And so in the Civil Service, my argument is that the top jobs should go to those who have shown that they are successful project managers, that they are men of wisdom who have actually brought something home, a project, a programme, in whatever field it is, that has been with Ministerial approval, designed, costed and implemented successfully. That is not what the Civil Service is now. The people who get to the top are the people who help the Minister get through the week in politics – a very important thing to do involving skills that you will need all the time, the ability to see that the PQs are drafted neatly, the ability to produce a speech for the dinner in the evening, for the visit to Brussels, the tactful management of delegations, the way in which awkwardnesses can be composed, all these things are absolutely vital in official lives but they should not be the way to the stars. You make them the way to the stars and everybody wants to be a Sir Humphrey, somebody who steals the words, somebody who displays some tact, somebody perhaps with a secret agenda. But anyway, my first point then is that, by the concentration of the top jobs going to those who have shown skills in project management, whether they are people who have spent their whole career in the Civil Service or whether they are people who have come into the Civil Service, perhaps people who have been in at the beginning, gone out and come back, project management success – that should be the way to the stars and to the top jobs, and all that means for the message it sends down in departments as to what you need to do in order to succeed.

The second thing that is needed to be done is to reduce 'churning'. Departments, agencies, non-departmental public bodies are constantly being set up, closed down, amalgamated, divided, multiplied; all these things cost money, confuse the civil servants who work in them because they quite often only find out about this by looking at the newspaper on the way to work because they have not been party to these changes, and not only does it confuse the civil servants who work in them, but also confuses the civil servants and interests who have to deal with a central government department. Suddenly you find that the department you are used to dealing with isn't responsible for this any more, it is somewhere else. When you track down where it is exactly, you find it is being dealt with by other people you have not met before. What do you get out of all this churning? Of course what you do get out of it is very often the adjustment of positions around the Cabinet table, but in terms of what you get out of it from the viewpoint of productive management is usually very little in the way of a contribution to a successful project devising or implementation. Look at the way in which in 2007 the Department of Trade and Industry suddenly reappeared as the Department of Business Enterprise and Regulatory Reform. Energy had been removed from it; one or two things had been added to it. How did that really help or assist the programmes for which the department was responsible? Very, very little. So the second thing is to reduce churning.

A third aspect which is important is in the devising and implementation of projects to aim for simplicity. It is often said that government is very complicated. It doesn't really have to be as complicated as it often turns out to be. This was very well summed up many years ago, in 1982 I think it was, some of you may remember Lord Rayner who was then the head of Marks & Spencer who was brought into government by Margaret Thatcher and did a series of studies on making improvements in reducing waste. And in talking to a Select Committee of the House of Commons, he said that policy must not be sacrosanct because highly educated and intelligent officials in Whitehall understand it and appreciate its intellectual qualities. We must specify in clear and simple terms what people are expected to do. That was as true in 1982 as it is today and it is something that is I am afraid still constantly neglected. An example of that – which I am sure is well known to some of you here this evening – is agricultural subsidies. A few years ago changes in Brussels required that a new system for the payment of agricultural subsidies should be introduced. The Department of the Environment, Food and Rural Affairs therefore set about redesigning the system of subsidies and they redesigned it in a way that was of course a brilliant intellectual construction by clever people who wanted a scheme that covered, at least in theory, all eventualities, that enabled the Minister to say whether he was talking about wheat or talking about sheep. It was all covered and all nicely thought out. The only thing was that it was so extensive it didn't fit onto the IT system so that farmers were not getting any subsidies at all! And of course then the farmers raised it with their Members; they had to borrow money from their banks very often, and it is quite interesting that in the United Kingdom there is not just one system for paying agricultural subsidies, there are four – there is one for England, one for Scotland, one for Wales and one for Northern Ireland. Well, it was the English system that was the most complicated and awkward; the other ones had some problems but not the same as the English one. So the result of all this was that while the original estimate of what would be necessary to produce a system was £76 million, it cost £122 million to devise a system which was defective, and we had to pay a fine of over £130 million in Brussels. So that was an example of a failure to face up to the question – what is this system of subsidy about? It is about helping farmers, getting money to the farmers quickly in ways that they can understand, that the junior officials who have to deal with the request can understand. But that had been neglected and in a way it makes my point, that if your fundamental skill is managing the week in politics you will make up a complicated scheme. If your fundamental skill is devising and implementing projects and programmes, you have a better chance of making a programme that will work and a programme which will be safeguarded against waste.

Assess the risks

Another aspect of reducing waste is by improving risk assessment in central government. It is often thought, often said, that civil servants in central government departments are risk averse. My argument is that they are risk ignorant; they take the most fantastic risks, falling off a cliff while denying this is what they are doing. An example that I think all of us remember some years back was passports, issuing passports. We've been doing it for a hundred years and it seemed to be the kind of thing that we knew how to do and then suddenly spring changed into summer and we found that passports were taking days, weeks, months, too long, to be issued. And why was this? This was because the Passport Office had decided to do three things at once. It had decided to redesign the passport regime in relation to children, it had decided to have a new IT system; and it had decided to move most of its staff to a new building. And it was doing all these things at once. Not surprisingly, all of them had risks attached but if you were doing them simultaneously rather than successively you got risks increased exponentially and you can see the way in which the failure to look at this programme for changing the way in which the Passport Office worked, now the Passport Agency, was a failure to look at the question of what did it mean for the people who were seeking passports or renewing passports. One of the things that was missed in this was the fact of course that once delays come in and people begin to find that they need to wait too long for passports, you are going to have a run on the bank effect and everybody piles in, so it wasn't just that you had, as it were, the first tranche of delays you had another tranche of delays added on the top of it. Now the Passport Office people of course said, well we did these things, I suppose they are connected in a way, but if we need to do it we'll do some more overtime. It was a time of feeling just, 'that's the way we do it'. There was no proper assessment of the risks attached to these three activities, or their interconnections or how this might affect the services provided to the people at large.

Another, perhaps even more dramatic example was the new system of tax credits. Tax credits, as you know, were introduced to help some of the poorer members of the community, £6 billion was spent in the first period of tax credits, and the scheme was introduced knowing full well that some people were going to get overpaid and that they may be asked to repay the money. No thought was really given to what sort of people had received all these tax credits. Overwhelmingly of course they were fair citizens of ours who were not used to handling money. If they had money, they spent it because they needed to. So when HMRC, Her Majesty's Revenue & Customs, sought to get the money back they found they couldn't because a lot of people were worried about that, they felt in some way they were illegal, would they go to gaol. Other people of course said, how lucky I am, I've got it. £2 billion had to be written off. So, we needed a better system, a more sophisticated system of risk assessment, a system of risk assessment that looks outward to citizens who are affected by the policies rather than just a system which can be negotiated up within the administrative machine.

Manage the money

In the Audit Office we had to 'qualify' the accounts of, not an enormous number of departments and agencies, but every year, twenty-five to thirty. In accountancy terms this is a sentence at best. If you are in the private sector and you get your accounts 'qualified' the share price disappears and your ability to survive is not there. But too often in terms of costings, too often in terms of examination of the cost of alternative programmes, the costings are just moves in the game, figures to argue for a pre-determined course of action and not the bedrock on which options and alternatives should be considered. If you look at the reports we did over the years, for example on defence, estimated costs of projects and programmes sometimes go up by 20–30% in a year. That was often because people thought (successfully thought) that the right way to start a programme is to suggest that it is not going to cost as much as you really think it will, so if you put in a low figure you hope to get it approved. You tell yourself, well, yes, we want this aircraft or this armoured vehicle now, let's leave out all the arrangements for reliability and maintainability, let's get it through the Ministry of Defence financial system, let's get it through the Treasury; once we've got it there, two or three years down the line we will put back the arrangements for reliability and maintainability. Of course life shows you that if you ever do put them back it costs an enormous amount more to put them back than if you had done it at the time. Often of course you can only put them back if you take out other aspects of the specification so in a sense it is the dishonesty of having a system of accounting in which, as I said, costings are too often used in the game in order to secure initial approval and not the bedrock which would have enabled you to decide whether to go ahead with the project or not. There is an enormous amount of auditing of one kind and another, examination of one kind and another, placed on central government departments and on local government departments, but often of course, because it is often overlapping, it is often duplicated, it means that very often it is not taken seriously and therefore outwitting it does again become a move in the game. One of the things that departments are supposed to do if they are making regulations under an Act is to make a regulatory impact assessment; this is supposed to tell you that if you have this regulation what are the benefits, what are the costs; is it worthwhile having it; if costs exceed benefits, don't have it. What we often found in the NAO was that the regulation was made and afterwards some kind of cockshy was made at a regulatory impact assessment. So it wasn't used for its purpose in deciding whether to do it or not, it was used to produce a subsequent validation or argument for it and often tendentious and weak it was as well. So a lot of money has been spent on running systems of oversight which, as I say, overlapped, were duplicated, were not taken seriously, and therefore of course led to waste.

Looking at the overall administrative picture, there are many structures and functions which could be abolished and save a large amount of money without affecting the quality of projects and programmes for the benefit of citizens. One example is those regional structures that we have: regional structures in the National Health Service and FHAs, and actually we like them. They don't really do anything, they are just ways in which material ideas pass between the departments and the trusts because there are six wheels on the coach. Regional Development Agencies are expensive to run, and again they could be abolished. We looked at regional structures shortly before I left the NAO and our costings showed that you could save £50 million a year by abolishing regional structures. The point is not of course that regional structures would be bad if they were real, but that they are not real, they don't actually have significance, they don't really as it were actually manage anything. They are presented as the response to the need for regionalism and actually they are only cloaks to disguise the centralising programmes and processes of the government. So we could abolish a lot of regional structures and save a lot of money. We could I think abolish the National Offender Management Service which uneasily runs midway between the Department of Justice and the Home Office and doesn't seem to add anything to projects and programmes concerned with the management of offenders but has created another bureaucracy – £90 million per annum we thought could be saved from this. So all these things would be important to do and all of them would help in reducing public sector waste.

and focus on objectives

Finally of course, I should say a word about public sector audit. The way in which public sector audit grew up was looking at whether the rules were followed, not whether the results were achieved. Now of course if you have rules you certainly need to follow them if they are rules about where the money is and where it goes, most certainly if they are to enable you to deal with fraud, theft and corruption. But too often the way in which public sector audit had developed was that the whole point was the rules, that all the effort went in to finding infractions of the rules. Certainly such infractions are significant but they are not something necessarily into which a lot of money had to be put by the auditors to find them out, and which then the departments would have to find some way of defending. When I first became Comptroller and Auditor General there was a species of files in departments called 'Not for National Audit Office Eyes'. There was a whole series of official papers denied to the Auditor and if anything underlined the point that here too was something of a game, it was that both sides had accepted this should be announced to Parliament, that there were these files and that this system obtained. I am glad to say we in public accounts addressed this issue, recommended to the government that the National Audit Office, like auditors generally should have a complete and unalloyed access rights to books, records and opportunities to discuss with the departmental staff.

The 1983 Act, which took the Office out of the Civil Service, also gave the Office the power to do value for money work described in the 1983 Act as 'consideration of economy, efficiency and effectiveness'. In the twenty years, and starting on the basis of the work begun by my predecessor, we sought to make a reality of that. Yes the Auditor should see that the accounts are properly prepared; yes he should, when he has evidence of fraud, theft and corruption, should bring that to public notice, but he should want the client to succeed, he should want the department to do well and he should recognise that people more often do better by looking at what has succeeded than by simply considering what has failed. If you look at what has failed it will tell you what not to do, but it doesn't tell you anything about what you should do if you aim to succeed. We recognise this in many aspects of life. If you are interested in athletics for example, you don't study the man or woman who gets knocked out in the heats of the 100m, you look at the man or woman who has won, and what was done to secure success, and what we have done in our work to eliminate waste was to look at what could be done to succeed, and many of the reports that we did were about what has gone well, how that could be extended, and how that could become a reality. We did a lot of work for example in the Health Service which was about capturing good practice: maternity services, treatment of Alzheimer's, treatment of heart disease. We looked – not just the auditors, we had people from the universities, from the Royal Colleges – at how success was achieved, how can success be transmitted, and we had a target that the savings coming from our work should be seven times the cost of running the office, then eight times and finally nine times the cost of running the office. And these were savings from the elimination of waste and these were recommendations that we made which have been endorsed by Parliament, accepted by the government, costed out with the department, so these were savings that were there for the taking, not money to be taken away from them, but money that was available because they procured goods and services better, because they disposed of assets that they were not using properly, that they chased up people who owed them money. And so in the last year that I was in the Office, the NAO cost £70 million to run and the savings were over nine times that. So this was checking waste not only by good management but also by showing how public services could be provided more successfully. This was essentially a recognition that government departments were bureaucracies. Bureaucracy of course, in some ways that's a bad word, but in another way of course bureaucracy comes out of the writings of people like Max Weber and bureaucracy, which talks about burdening the administration, which talks about recruitment on the basis of demonstrated merit, which talks about promotion on the basis of accomplishment, and certainly bureaucracy is a better system of running public administration than cronyism and giving jobs to your brother-in-law and cousin. But the thing about bureaucracy is that people look inward rather than outward; the way to the top is through arranging the Minister's diary rather than providing services in ways which make sense to the system.

CORRECTION

In Britain & Overseas Winter 2008 page 31 line 29 should read '28 billion barrels' not '280 billion barrels'.

ENERGY SECURITY – A PANEL DISCUSSION*

Contributions made by an economist, an environmentalist, and industrialist, a shadow minister and a government minister to members of the Economic Research Council on Wednesday 28th January 2009

Security depends on diversity of supply

Extracts from the contribution made by Colin Robinson, Professor Emeritus Surrey University, former Energy Economist of the Year.

I think when you are talking about energy security it is quite important to try to define what you mean by energy security. Clearly you can't have absolute security of supply so what you are talking about is relative security, which I think means relative freedom from typical interruptions and the kind of price spikes that go with them, so that's a kind of definition of energy security. It is also important to consider to what extent secure energy supplies emerge naturally from markets and therefore the extent to which governments need to step in. Governments tend to assume that they need to step in of course, though to be fair to the present government and all the administrations since 1997, they have given pride of place to markets in providing security. The reason that competitive markets provide security is because security is an important characteristic of any energy product, and consequently people are prepared to pay for it, a premium for energy security. Therefore there is no reason to believe that energy security will be underprovided so long as the market is competitive. Consumers want security of supply and therefore it pays producers to provide it. So even Russian gas suppliers have to worry about their reputation or the implications of not providing secure supplies. If you don't provide secure supplies you find that the demand for your supplies will tend to decline and you may find that there is an insecurity discount applied to your price. Markets will also develop means of dealing with potential security problems, as long as governments allow them to do so. For instance, forward markets in gas, oil and other commodities provide means of securing supplies in the future and they signal requirements for investment, for people to provide new capacity. So there are all sorts of ways in which in markets security of supply is provided. An interesting question is whether the government

* Special thanks to City Forum for supporting this event.

can enhance this market provided security. I think the general view is that government can, but it's something on which I certainly beg to differ for a number of reasons. One is that, if you look back in history, this view is very doubtful – that governments actually do enhance security. You can think of all sorts of examples, but British coal mining is the main example of course; if you go back many years, for decades British government supported British coal in order to provide secure supplies as they thought but they actually provided insecurity by handing monopoly power to the British coal industry and its unions. So that kind of action, where you prop up a domestic industry in the hope that it will give you secure supplies, is not a very good way of providing security; it tends to lead to the opposite result. The last thing you want to get secure supplies is monopoly. The key to security is diversity of supply. There is also a danger that when government comes into a market and says it is providing security, it will crowd out private provision. Government intervention to provide security may well encourage the belief for instance that, if you get into an insecure situation, prices will be controlled and that will reduce the incentive to invest in security. Furthermore, government action in the real world tends not to be based on wise far-sighted considerations, but tends to be pushed around by categories, and that's not a particularly good way of providing security. *So my view about governments and security is that security is primarily something that should be provided by markets – provided markets are competitive*. Monopolised markets won't do it. But there are a number of things that government could stop doing that would help to improve security. One thing I think would be to change the approach to environmental objectives; it's time I think they accepted that electricity has actually been privatised and that generators should make their own fuel choices and that would do a great deal to reduce political uncertainty about support for different energy sources. In effect we have carved out quotas from renewable to maybe the same for nuclear and so on. It tends to produce very unreliable supplies because the whole thing becomes subject to political uncertainty. Easing planning restrictions, as the government is doing, is another good way, stopping doing things which in the past had tended to produce insecurity, and finally in my quick list of things that would be useful to do, is to continue to push for a liberalisation of European Union energy markets. We have been trying for many years to get European Union energy markets liberalised, but unfortunately they are not; there are too many national champions around state-supported industries, and it would be a great deal better if we could have liberalised markets across the Channel because that would help very much, I think, to increase security of supply to Britain.

What we must not do

Extracts from the contribution made by Tom Burke, Environmental Advisor, Rio Tinto and former Director of Friends of the Earth

I was intrigued by this invitation – please come and talk to an audience of economists about energy security and would you do it in five minutes. I thought that was quite a challenge and one I couldn't resist. I want to say it is quite important, when I thought about how I would do that, quite important to bear in mind that economics and politics aren't the same and you need to be very careful when you stray from talking about economics into the point where you are talking about politics and I will try to avoid doing that.

I have got four propositions. The first proposition is that energy security and climate security are two sides of the same coin; that no government is going to abandon energy security as a goal of public policy, and quite rightly so, the lights are not going to go out; no government would survive the lights going out, or whatever else you mean by that rather sound-bitey phrase. But neither are governments going to abandon the efforts to ensure there is a stable climate and therefore will take whatever measures are necessary to resolve the dilemma between the growing demand for energy and the growing need to reduce the burden of carbon in the atmosphere. So that defines the way in which we are tackling or approaching the problem of energy security; we have to resolve the dilemma, not choose which of the horns we would prefer to be gored by.

To sum up a state of where we are in climate science if you like, what does it mean in real terms? We are looking at a carbon-neutral energy system by round about 2050. That's a global energy system. So that's the frame in which we have to establish energy security. I get pretty annoyed when I listen to discussions about energy security because there is a conflation into one problem of four separate problems which have different dynamics and different solutions. We wrap them all up in something called energy security as if it were all one thing and it's not. There is the problem with oil security which is different from the problem with gas security – oil markets are global, gas markets are not global, for instance. That's different again with coal security, with which we don't really have a problem at all, which is different again from electricity security, which really does matter because, even if it takes three days to shut the country down if you lose your oil supply, it takes a little bit quicker if you lose your electricity supply. Those have very different problems from each other, and the idea that there is some one-size-fits-all solution to the energy security problem misunderstands the point. If you are really concerned about not losing your oil, you perhaps might have thought about that before you invaded Iraq because the biggest threats to oil security are geo-political; the biggest threats to electricity security are actually energy policy and investment, getting the right mix, the right investments, the right policy to generate the right investment. It is a very different problem.

Solving that problem, resolving that dilemma is well within technological and economic competence. We will not be constrained, either by technology or by capital, from resolving that dilemma satisfactorily. Our real problem is a political problem and we are not very good at solving that political problem. We have a political discourse on energy which is hide-bound by an economic theology dominant in the Treasury which says, price is your answer, and that's it. It ignores the fact that prices are volatile discouraging high capital, long-life investments. In fact we have seen all kinds of price effects that haven't produced in the real world what the economic model actually suggests they will produce. So we need to think a bit more broadly in our political discourse about what actually is going to make a difference.

And we need to avoid a taste for gigantism. Politicians have a real taste for things they can show you that are big that make a difference. Governments can't pick winners and shouldn't pick winners. When the Prime Minister picks a winner and says it is nuclear power, it is largely because it's big and solid and looks like it might deliver. I don't think it's got a chance of delivering, but that's beside the point.

And the final point to make is that, if we don't get the stimulus tactics right in a way that drives us towards a low-carbon, highly energy-efficient economy, then we run a real risk of stalling the recovery. By the way if your core political project is smaller government, light regulation, lower taxes, you believe in an ever-expanding, rather personal freedom for six and a half billion individuals and you think that markets are always wiser than government, you are probably not going to solve this problem.

Politicians must stop dictating the fuel mix

Extracts from the contribution made by Jeremy Nicholson of the Energy Intensive Users Group.

For those of you who are not aware, I work for energy intensive industries – steel, chemical manufacturers and so on, that depend utterly on having access to secure and internationally competitive energy supplies to remain in business, and if you imagine for a steelworks 25% of your costs might be energy related, for an aluminium smelter 40%, for an industrial gas business it might be 70% you can understand why that matters; it is critical for your business and incidentally so too is energy efficiency.

I strongly support a market-led – not necessarily entirely market-led – energy policy and am very sympathetic to the views that Colin aired earlier on. I would put an important caveat though. Markets cannot work if politicians will not let them work. The problem to date, it's been a problem with this government and I'm sure it could be a problem with a future one, is the tendency to meddle and to dictate outcomes for that market will render it less effective, less secure and less competitive than it would otherwise be. We have gone through a relatively benign period, despite some recent price rises, as far as energy security is concerned. We were flush with indigenous gas from the North Sea – that's in long-term decline now – and we have put off difficult decisions about replacing nuclear, and we've got some environmental constraints on the operation of coal, and this is all coinciding at pretty much the same time and we are approaching a crunch in the run up to 2015. Some numbers for you: there's around 70 gigawatts of power generation in this country. This winter, we have been seeing about 50% of our power generation coming from coal – typically around 24 gigawatts a day. We are going to lose 12 gigawatts of largely coal and some oil-fired power stations by 2015 at the latest, possibly earlier, as a result of reduced running hours, as a result of the large combustion powers directive piece of EU environmental legislation, what they call CO_2 emissions, but what I call real pollution. And that secure hedge against gas insecurity will be lost to us if we do not replace some of it with coal. Now it is a lovely idea to think that there can be clean coal in the long term, maybe it will be, but the technology that is available today and fundable, is 20% more carbon-efficient than current coal-fired stations, and a lot cleaner in terms of its other emissions. That is a step in the right direction, and I would argue we can't deal without that in the interim. Don't forget we are also set over the next ten years to lose around 7½ gigawatts of nuclear power too, and there is an urgent need for that replacement. I think credit is due to the effort that is now being devoted by government, and the Opposition too, to ensuring that nuclear capacity is replaced as soon as it can be. We shouldn't be paranoid about gas dependency and import-dependency, but it does need to be managed. We need a contractual framework to ensure that we are not just at the mercy of spot prices, having to outbid the rest of the world for cargos to arrive, and critically we need a physical ability to store gas here, we don't have anything like enough of it in this country. Just to put that in perspective, if you compare the gas storage we have now, which admittedly is increasing though not fast enough, we have something like 4% of annual demand that can be stored within the UK, compared with around 25% in France and about 19% in Germany. Those figures are changing, they are moving in the right direction, but not fast enough. More needs to be done on that.

I mentioned earlier that I didn't believe markets could work without freedom from the wrong kinds of government intervention, and I must mention the renewables target here, which is in my view absurd. 20% of our energy is apparently going to be renewable in 11 years' time, and to meet this target, 35% of our electricity will have to be renewable – a big increase from the 5% or so we've got at the moment. The government seems to believe that there is a potential (whatever that means) for 25 gigawatts of offshore wind to be built by then and a comparable increase in on-shore wind that will take us close to that 35% target. Their own figures say this could cost £100 billion and put 50% on an industrial user's bill and incidentally destroy ½% of GDP.

We need a balanced approach to energy security, recognising that the likes of wind can provide seasonal security on average, but I don't want the lights to stay on 'on average', I want them to stay on when I press the switch, and we don't have instantaneous security from wind; there are regular periods that we have experienced this winter when the output has been close to zero. We need therefore to maintain conventional back-up.

So to conclude, we need a balanced approach on this. We need to recognise that markets can work but for heaven's sake, politicians, *stop dictating the fuel mix*.

Security depends on self-sufficiency

Extracts from the contribution made by Bernard Jenkin MP, Former Shadow Energy Minister and member of the House of Commons Defence Select Committee.

I am going to concentrate more on the security aspects of energy security because you've had some very able presentations about the energy related bits of energy security. In fact the National Security Strategy, published last March, recognises that international competition for energy resources is what it calls one of the, and I quote, 'drivers of insecurity'. Global energy demand is expected to increase by 50% by 2030 and we shouldn't kid ourselves that the present financial crisis is going to, in the long term, dampen energy demand. It is very difficult to de-link economic growth from energy demand. There has been some success in that but generally energy demand goes up in a linear relationship to economic growth. The government describes competition for energy as a global challenge in its own right, and one of the biggest potential drivers is the breakdown of the rules-based international system and the re-emergence of major inter-state conflict as well as increasing regional tensions and instability. And it is not comforting to realise that, particularly fossil fuels, things like uranium – a lot of uranium – and crucial other metals for energy production are concentrated largely in the least stable areas of the world where the population growth is the highest, where the effect of global warming is likely to be most severe, and where migration and extremism – particularly Muslim extremism – is concentrated. It is a heavy concoction and any idea that we went into Iraq to stir up the oil markets is obviously absolute baloney; that was not the reason for that war. The government has recognised the severity of the potential threat caused by energy security but, as with so much of the national security strategy, it is good on the analysis but very short on the solutions. Tackling climate change seems to be what takes up most of the government's ideas for building energy security, but it's not the panacea for the world's energy problems, and the government would be more convincing on energy security if it had used the last twelve years to promote the kind of domestic diversification of energy production in this country that everyone is now talking about.

It is interesting how people divide up energy security. I would look at energy security in three categories: short-term, medium-term and long-term threats. In the short-term, they include accidents with infrastructure, terrorist attack, disruption of supplies; there are quite a lot of short-term threats to our energy security and in fact we have had an unusual number of brownouts and blackouts as a result of stress on our energy networks which have been remarkably unreported in this country. There has been a spate of blackouts in the north-east at one stage which, had they happened in Shepherds Bush around the BBC, I'm sure would have been much better reported. But that's the nature of our London-centric media. Add to that the very limited spare capacity particularly that we have got on gas, we are vulnerable to shocks and to the disruption of foreign supplies, and we have seen just this winter how Russia, acting in a very arbitrary and vicious fashion, has caused severe energy security problems for eastern European countries. They caused price problems for us over here but they haven't caused us major disruption, it would have to go on longer than that. But actually we are relying on other European countries with their very much more considerable cushions of emergency stocks because North Sea is now on the decline. What we used to regard as an inexhaustible reserve of gas supplies now has limited capacity to produce gas and therefore we need on-shore reserves in order to maintain our gas supplies, and so much of our electricity is generated by gas that if all that starts going off line then we are in trouble.

So we really need to look at our policy towards Russia and building more pipelines to reduce the Russian monopoly on piped gas supplies and oil supplies. At the moment, NATO is completely divided, the EU scatters to the four winds under pressure from Russia, with Italy and Germany taking one view, and other countries like Britain taking a different view. Russia is very good at dividing and ruling on energy security as on other things.

In the medium-term we have got the hiatus in electricity generation which you have already heard about; I won't repeat that. But it is just worth bearing in mind that there is going to be no quick fix for the mess that we are now in. Even if we push the green light for six nuclear reactors now we would not plug the gap that we are going to be left with. What's obviously got to happen is that that EU Directive that is going to shut down a lot of our dirty coal-fired generation is going to have to be delayed. It is the only option. That stuff's going to have to remain available in order to stop the lights going out. And it is extraordinary, when you analyse the whole energy debate in a triangle of three objectives: you want cheap energy, you want a low price – that's one end of the triangle; you want green energy, you want environmental energy, you want energy production that doesn't hurt the environment, and you want secure energy – and those are the three edges of the triangle. But actually they are in a hierarchy, those things. If the energy supply is secure then people want to set a reasonable price, and if it's come in at a reasonable price, then they will start thinking about the environment, and I promise you if the security becomes unreliable and the price unreasonable, I am afraid all our environmental objectives will be the first to go because politicians will not be able to hold the line on the environment if people are being impoverished by energy prices or they are being left in the dark.

I must comment on the economic debate here. I am a free marketeer. I believe in markets, but not for energy. Because energy has a peculiar quality; energy is now like the oxygen we breathe in our society and the penalty is too high if the lights start going out, so it is a political issue, it cannot be divorced from politics, and there is also an very unsatisfactory aspect of economics in energy. It is the Micawber principle; if you are producing 20 gigawatts and only 19½ gigawatts are required, you have a surplus and the price will fall and your capacity will become only marginal and you will start losing money. And when we privatised the industry in the 1980s, all that base-load nuclear stuff that had to be on all the time lost a very great deal of money because it couldn't produce. But when there is a shortage the price goes stratospheric but it doesn't produce any more electricity because of the lead times involved. So I think the government has therefore got to regulate the market in order to ensure that the investment comes through.

Finally, let me look at the long-term threats. The long-term threats are principally – we are going to be importing 80% of our natural gas by 2020. Think about that, we were self-sufficient just a few years ago. We are competing with Asia and China for liquid natural gas. We are competing with other countries and then there is the political disruption and piracy and the geo-politics of energy so it is going to get very much more complicated, which is why everything should drive us towards self-sufficiency. *By any means whatsoever we ought to get to self-sufficiency at a reasonable price*, and that ought to be the priority and then we will be able to implement our environmental objectives as well.

Government needs to be smart intelligent and wise

Extracts from the contribution made by Malcolm Wicks MP, Energy Minister 2005–6 and 2007–8, and the Prime Minister's Special Representative on Energy Issues.

It seems to me that as a generalisation we have three challenges when it comes to energy. One is about climate and I don't know whether I believe the science on climate change, but I think that has to be our over-riding priority. I do think the government has set the most challenging targets probably any government has ever set on anything, namely that by 2050 we want to see an 80% reduction in our carbon emissions. The second issue of concern to our businesses and of concern to our constituents is affordability. Our constituents have been frightened in winter-time by the extraordinary increases we have seen in electricity and gas, and we always have to bear in mind the issue of affordability, not least because some of the new technologies, which are part of the solution, are very expensive.

And the third issue is the one we are discussing today, namely energy security, and I will focus on energy security.

I will just share this with you. When I was Energy Minister, which I was more or less for three years, if anything kept me awake at night – I don't mean this literally but if anything was always preying on my mind – it was not so much climate change, because that was clearly on all the agendas that count, good people were worrying about that and I think we were moving in the right direction as a government and as a parliament, but what preyed on my mind was the nation's energy security, and I am pleased the Prime Minister has asked me to produce a report for him by the summer, on which I am engaged with colleagues from my former department. We have heard much of this, but, notwithstanding the recession, in this century there is going to be a huge global grab for energy going on, and we know why. We have the great emerging economies of China and India, and we cite those two, but you can add to that Southern Africa, many other economies growing in South America and so on. But that growth will be fuelled by energy, mainly by fossil fuels, and when we come out of recession we will see the price of a barrel of oil rise again to I suspect very startling levels. We are experiencing at the moment of course the most extraordinary volatility – a very low price now; only a few months back $147 a barrel. The wise people who write in the financial pages (and we know they always get it right, don't we?) are predicting that it will go up to $200 a barrel. But those kinds of prices will return when the world comes out of recession and I agree this is a geo-political issue as well as an environmental and economic and social issue.

Now, where are we in the United Kingdom, given what has just been said? We are in a situation where, having been more or less self-reliant as a nation for our energy from the days when we used to burn our wood and coal and then the blessings of the North Sea, we are now into an era, and the change is happening very quickly actually, whereby we are importing more and more of our fossil fuels, including coal – two-thirds of the coal that we burn in Britain comes from abroad, quite a lot of it from Russia as a matter of fact – and I think by 2020 maybe 80% of our gas will be coming from overseas. So dramatic things are happening in terms of our supply in this country and of course you can draw the analysis about Europe where Europe becomes – I won't say dependent – but anyway heavily involved in Russia and Gazprom.

So there are some challenging trends out there and I think it is therefore very useful that we are having this seminar, and we need to have a discussion, and we need to collect the intelligence and the analysis of energy security, and first of all I think we need to pose the question, what do we mean by energy security? On one level the answer is easy: we need the stuff, we need adequate supplies, we need to keep the lights on. But I think by energy security we mean something slightly more sophisticated as well, namely that we have to ensure that we get our energy in Britain and in Europe in such ways that it doesn't jeopardise our independence as a nation, to have our own foreign policy, to stand up for human rights, to talk intelligently and bravely about the retreat from democracy in Russia and so on. In other words, we mustn't become so dependent on a source for energy that it threatens, if you like, our UK dependence. And I think that is partly what the debate is about, alongside the rather critical issue of where we actually get the stuff from.

Now in terms of a strategy, it seems to me that for a long time we will need to be importing a great deal of our coal, our gas and our oil – that is a reality. What we need to do of course is to make sure that we are not over-reliant on any one country, on any one part of the world, on any one region. We need as many pipelines as possible – the southern corridor from the Caspian is something I am particularly interested in – and we need to make sure that LNG (liquefied natural gas) comes Britain's way. Soon, I think, the Qatari gas at long last is going to arrive at Milford Haven, for example, and we have the Langaled pipeline of course as well from Norway, so we are not in an altogether bad position. In other words, *we need to be smart and intelligent and wise* about external sources of supply.

Secondly, and here I agree with Bernard, we need to do our utmost to maximise what we might simply call home-grown energy. And so in terms of a domestic strategy, what do we need to do? We should start with energy demand. There is massive potential in this country to reduce our demand for energy in terms of our housing, our buildings, our factories, our transport systems. So energy efficiency, reducing energy demand, has to be top of this agenda, just as it is top of the climate change agenda. Second, but in no particular order, we will need to use fossil fuels and of course we need to develop those technologies that enable us to burn those fuels cleanly and greenly as possible, so that's why I – and I know Tom is the global authority on this and very interested in the technology, he knows carbon capture storage or sequestration, which will allow us in the future to burn our coal but to do it in a way that doesn't harm our planet.

Third, renewables will play a significant role. At the moment only 1.5% of our total energy comes from renewables, and only 5 or 6% of our electricity. The government has a target that 15% of all our energy should come from renewables by 2020 which could mean that about 35% of our electricity will come from renewables by 2020. Jeremy has described this as challenging and he's right.

Finally, nuclear. Nuclear is controversial, it is complex, there are a number of really important issues to tackle. I think this Labour government was right to set up a review to look at our energy policy again, and to look at nuclear, and I think the British government, now I think with the support of the Conservative Party, both parties are in agreement that there should be a new generation of civil nuclear reactors. I think that is the right decision; it is a bold decision; it makes sense in terms of national security.

And I think what we are now into is an interesting debate about the respective roles of the market and the state. Gone are the days when the state did everything, with a Minister for Power, and the CEGB and all that kind of stuff. Gone too is the second phase where a former government thought, basically leave it to the market and all is well, a little regulation but basically the market will deliver. I think we are now into a much more interesting or grown-up phase where we are talking about government with some clear objectives about security and affordability and climate but leaving it to the market to deliver, and I think around that dynamic between the market and the state is a sensible debate.

THE GREAT CHOLESTEROL CON

By Dr Malcolm Kendrick. Published by John Blake publishing p/b 2008. Price £7.99

'I hope nobody here is taking Statins' was the conversation stopping entrance statement of a friend recently at a social gathering of 50 plus year olds. As we stood there – many wearing a barely covered sneer – she made her case against statins in just a few sentences and then reccommended reading *The Great Cholesterol Con*. As it happens I had good reason to take notice – a couple of friends had told me that they were taking statins alongside aspirin every day, Dr Thomas Stuttaford, The Times doctor had recently opined that it would be a good idea for more or less everyone over 60 to be taking this wonderful product and I had accordingly prevailed on my somewhat reluctant GP to prescribe them for me. It is quite the fashion.

The economics of statins, or at least the costs of them are significant. Kenrick notes that 'Currently, they are the most expensive single item of NHS drug expenditure – over £1 billion per year' (page 173). Add to this another £l billion for the costs of yearly cholesterol tests, six month reviews by GPs and the payments to GPs for getting blood cholesterol levels down through the Quality Outcome Framework system and one has a sum of money that would otherwise employ an extra 70,000 nurses or build several new hospitals. In other words we are talking big money and a major slice of drug company profits.

Statins were developed only a decade or so ago from some far eastern poisonous plants because they can reduce blood cholesterol levels thus, it is claimed, reducing the extent to which one's arteries fur up with fatty deposits which otherwise would force the heart to work harder and lead to heart attacks. 'Everyone' knows this and the cognoscenti know that there is 'good cholesterol' and 'bad cholesterol' so that if statins reduce the 'bad cholesterol' they must indeed be a wonder drug.

This review cannot do justice to a major medical controversy but the counter argument is that the body (and in particular, the liver) sends cholesterol around (performing very necessary functions) in lipoproteins (which is what is actually measured) and the number of these lipoproteins naturally and usefully rise with age. Taking statins will reduce the lipoprotein count but there is no evidence of this making any difference to life (age) expectancy. There is however, good reason to conclude that there are some worrying long term side effects. Kendrick notes:

> Statins cause muscle pains and muscle weakness in up to 20% of people who take them; statins cause rhabdomyolysis, which can be fatal; one type of statin, simvastatin, over a period of six years, caused 416 deaths in the USA; statins cause polyneuropathy; statins cause memory loss, depression, confusion, irritability and dizziness; and; statins cause major birth defects. (page 201)

They may also contribute towards both cancer and even heart disease. After reading the book twice, a brief Internet search on the subject and a further and longer consultation with my GP, my expensive statins have been binned. My lipoprotein level has now returned to the allegedly slightly high level which my own body seems to have set for me.

But if the high cholesterol level, furring up the arteries theory of the cause of heart attack is wrong, then what does cause heart attacks? Kendrick presents an alternative – that furring up occurs as a result of stress which causes damage to arterial walls which the body repairs with tiny scabs which build up over time. His chapters on the causes and effects of stress are both convincing and instructive. He presents a well argued case and does not evade the issues at stake. Enoch Powell once commented to me that one is ‘a physician or fool by forty’ which I take to mean that we all have a responsibility to at least try and understand what is prescribed for us. He would, I suspect, have relished reading this book.

J.B.

THE FINANCIAL CRISIS AS EXPLAINED IN *THE IRISH TIMES*

Linda is the proprietor of a bar in Cork. In order to increase sales, she decides to allow her loyal customers most of whom are unemployed alcoholics – to drink now but pay later. She keeps track of the drinks consumed on a ledger (thereby granting the customers loans). Word gets around and as a result increasing numbers of customers flood into Linda’s bar.

Taking advantage of her customers’ freedom from immediate payment constraints, Linda increases her prices for wine and beer, the most-consumed beverages. Her sales volume increases massively.

A young and dynamic customer service consultant at the local bank recognizes these customer debts as valuable future assets and increases Linda’s borrowing limit. He sees no reason for undue concern since he has the debts of the alcoholics as collateral.

At the bank’s corporate headquarters, expert bankers transform these customer assets into DRINKBONDS, ALKBONDS and PUKEBONDS. These securities are then traded on markets worldwide. No one really understands what these abbreviations mean and how the securities are guaranteed. Nevertheless, as their prices continuously climb, the securities become topselling items.

One day, although the prices are still climbing, a risk manager (subsequently of course fired due to his negativity) of the bank decides that slowly the time has come to demand payment of the debts incurred by the drinkers at Linda’s bar.

However they cannot pay back the debts. Linda cannot fulfil her Loan obligations and claims bankruptcy. DRINKBOND and ALKBOND drop in price by 95%. PUKEBOND performs better, stabilizing in price after dropping by 80%. The suppliers of Linda's bar, having granted her generous payment due dates and having invested in the securities are faced with a new situation. Her wine supplier claims bankruptcy, her beer supplier is taken over by a competitor.

The bank is saved by the Government following dramatic round-the-clock consultations by leaders from the governing political parties (and vested interests).

The funds required for this purpose are obtained by a tax levied on the non-drinkers.

THE LATE ALAN WALTERS AND THE PRESENT CRISIS

Lord Griffiths, Head of the Prime Minister's Policy Unit 1985–90, and a close colleague of Sir Alan Walters, commented in The Times (6/1/09)

Alan was a friend whose professional judgement I respected greatly. One can only speculate what advice he might have given today in the light of the resurrection of Keynes. I suspect he would have laid the responsibility for sterling's collapse – a reflection of the loss of investor confidence in the currency – firmly at the Treasury's door, in particular because it allowed public expenditure to grow out of control. He would reluctantly have rescued banks but not with such penal costs of borrowing. He may well have felt that the Bank of England has dragged its feet ever since Northern Rock and could be more creative in increasing credit.

Although he was a Manchester liberal at heart, he wasn't ideological when it came to giving advice. I think he could have accepted the need at present for a modicum of Keynesianism or for allowing public spending to rise provided there was a medium-term framework through which the economy could be returned to stability.

LETTER

An insider's interpretation of boom and bust from Mr David Fifield

It has been suggested UK boom and bust cycles are over. Recent events have proved otherwise. A replacement view, based on 'not guilty guv' holds we have been overtaken by a global crisis/crunch.

In the early 90s three UK reports aimed at correcting perceived business shortcomings were generated. In 1992 'The Financial Aspects of Corporate Governance' (The Cadbury Report), in 1995 'Tomorrow's Company: The Role of Business in a Changing World' (the RSA's report) and in the same year 'Directors' Remuneration', (The Greenbury Report). I was a contributor to the first and a subcommittee member on the second.

The Cadbury Committee was established in May 1991 in response to concerns about accounting standards for financial reporting and accountability, heightened by problems with BCCI, Maxwell and a controversy over directors' pay. The Committee was set up by the Financial Reporting Council, the London Stock Exchange and accounting professions. Having sought views from a wide range of interested parties the committee reported in December 92. Recommendations concentrated on UK listed companies and a code of best practice. Topics covered were: companies supported by their auditors to report at year ends on compliance with the code, a limitation on the length of directors' contracts, greater use of non executive director input, expansion of interim reporting, enhanced audit effectiveness, directors to confirm their businesses as going concerns, shareholders as owners to encourage acceptance of the code.

On the 5 December 1990 Professor Charles Handy delivered the Michael Shanks Memorial Lecture, 'What Is a Company For?' The lecture lead to the RSA's inquiry, partly funded by the Midland Bank, 'Tomorrow's Company'. The inquiry used subcommittees to examine specific topics aided by an input from the Fellowship. Findings, presented on the 4 June 95, set the corporate goal as competitive success based on a clear view of purpose and values. To achieve this five key relationships were identified, customers, employees, suppliers, shareholders and the community both locally and at large. With the sub committees having their thoughts merged we have, The Inclusive Company.

The Greenbury Directors' Remuneration Study Group, a CBI initiative, responded to public and shareholder concerns for UK PLC Directors' rewards. Its Code of best practice, published in July 95, suggested all listed companies should comply. Boards of Directors were to establish remuneration committees of Non-Executive Directors acting on their behalf and that of shareholders on the subject of remuneration, pension rights and any compensation. The Study Group also considered large pay increases and share options for some recently privatised utilities.

From a general perspective with the present global recession starting in the US and UK are there 'Anglo-Saxon' business characteristics that might encourage boom and bust? There may be. Walter Russell Mead in his book 'God & Gold' identified a successful economic model first established by the Dutch, adopted by the British and followed by the US. Three hundred and fifty plus years ago the Dutch built a navy that dominated trade routes and introduced joint stock companies plus the first stock exchange. They also experienced the first speculative bubble in the 1630s, tulip mania. With the Dutch invasion of Britain, 'Going Dutch' Lisa Jardine, the UK took on and improved the Dutch model. It was a proactive/democratic global model with goods and services imported and exported, eg The East India Company, traded company ownership, delegated employment responsibilities etc. To prosper the model relies on trust plus 'competitive controlled greed'. It follows a bubble might arise during times of confident growth, a generous attitude to greed supported by compliant political interests. Bust follows along with the necessary corrective pain when the tide goes out *a la Bernard Madoff*.

Moving forward, with Anglo-Saxon models booming, the UK economy was ready for a fall. With home ownership an infectious desire, politicians keen to please in order to keep power, banks up for a profitable challenge, the catalytic ingredients were in place for a grand bubble second to the US.

It is interesting to speculate. Had the Cadbury/Greenbury codes carried greater long-term influence, would the UK now find itself better placed? Reflection also asks where were the accountants when it came to the concept of 'going concern'. An extract from my letter, FT March 1992 agrees. 'One has to ask how accountants have achieved their power within the UK business world. This I believe can be traced to the importance of the stock market in corporate ownership, with power delegated to senior managers. The accountant in this scenario acts as a policeman working on behalf of the owners'*. May I suggest the accountants fell down on the job when it came to the banks?

If we wish to reduce the frequency and scale of future booms and busts I believe we need to pay greater attention to the basics as presented in the Cadbury/Greenbury codes, while placing more emphasis on quality and less on status competition.

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* Philip Whitchelo's letter 'Accounting sleights of hand replaced by puffery' FT March 2nd 2009 appears to agree.

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iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

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Baker Tilly
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