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

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# THE FORTUNES OF THE BRITISH ECONOMY – NOT FORGETTING THE SCOTTISH ONE

*A talk given by Lord Forsyth of Drumlean, Chairman of the 2006 Conservative Tax Reform Commission, to members of the Economic Research Council on Wednesday 15th July 2009*

## The Union and Finance, 1707 and now

Scotland's reputation, built up over more than 300 years for prudence and skill in financial services has been severely damaged by the collapse of the Royal Bank of Scotland, HBOS and the Dunfermline Building Society. The first engagement I carried out as Secretary of State was to speak at the dinner celebrating the tercentenary of the Bank of Scotland. Like all Scots I was proud of our financial institutions and the key role Edinburgh played as a financial centre.

Alex Salmond's conduct has been well, just embarassing. His call for an independent Scotland *to join Iceland in an arc of prosperity* rivals George Robertson's *devolution will kill nationalism stone dead* or the Prime Minister's *no more boom and bust* for catastrophic errors of political judgement. His analysis of the collapse of HBOS as being the fault of spivs and speculators showed the same sophistication that he brings to making his case for independence. The Union in 1707 saved Scotland from the consequences of a speculative bubble and more than 300 years on it has done so again.

## Stealing from our children

The American commentator William Safire described Britain under the last Labour Government, before Margaret Thatcher became Prime Minister, as a first class example of how to ruin a first class country. All Labour Governments leave office with unemployment and debt higher than when they took over. This Government has excelled itself with even the all party Treasury Select Committee suggesting we could be heading for 4 million unemployed. Gordon Brown inherited a golden legacy from John Major in 1997. Our economy was the strongest it had been for a century. Unemployment was falling by 50,000 a month – now it is rising by 140,000. Borrowing in 1997 was £35 billion. Now borrowing is out of control and Treasury forecasts have the credibility of Billy Bunter's postal

order. The Government are planning to borrow £269 billion *more* over the next 5 years than they were just 8 months ago. They will need to sell an astonishing £900 billion of Gilts. Who will buy them? Interest rates will have to go up to get them away. That means higher mortgage and credit card payments after the election. Next year's borrowing will be the highest since the second world war and the Government are planning to double the national debt to £1.4 trillion. That's more than a trillion pounds more than it was when they took office.

Borrowing is just taxation deferred and it will take a generation to pay this back. The interest on today's debt alone already exceeds the whole of the Scottish budget.

Gordon Brown started off by stealing £5 billion every year from our pensioners with his foolish and damaging tax raid on the pension funds. Now he is stealing from our children.

## The Brown Bottom

Public spending has doubled from £320 billion to £623 billion but who believes education or the NHS is twice as good. Our GPs may be better paid but it is harder to get a doctor at night or at a weekend. There are more than 5 million people on out of work benefits and the number and proportion of young people not in education, employment or training is higher than when Labour took office. People on the lowest incomes are paying effective marginal rates of tax of 90%. The Government wasted £12 billion cutting VAT by 2.5% but they are imposing new taxes on jobs with higher NI contributions and by putting VAT on the salaries of workers supplied by agencies. If you earn a £100 a week and double your income you will be allowed to keep just £5 or £6 of that extra £100 after tax and loss of benefits. If you are a private equity millionaire buying and selling companies, geared up to the gills, your marginal rate of tax was until recently 10% on the gains made, thanks to a Gordon Brown initiative on taper relief. It is now 18%. That's the same Gordon Brown who against advice told the market, in advance, that he was going to sell off our gold reserves, depressing the price at the worst possible time. He off-loaded 400 tons, half our gold reserves at an average price of $275 an ounce; now known affectionately in the market as the Brown bottom. Gold this morning was $925 an ounce so he threw away around £5 billion of our money. Why?

The Prime Minister does not seem to have much luck with Gold. He has squandered the golden legacy and his golden rule turned out to be

an elaborate con to justify borrowing money at the height of the boom when revenues were pouring in from City bonuses and stamp duty. The tax revenues Gordon thought were permanent and based his spending plans on, were temporary revenues that came from the bubble. These have now evaporated leaving a black hole in the budget which he is filling with borrowed money. We need a plan that shows how debt will be paid back in the medium term and where the reductions in planned public expenditure will fall. We will not get one till after a general election as the Government fears levelling with the British people and fears the political consequences. The country needs an election now and a grown up debate which ends this period of wishful thinking and denial.

## Cheap goods, cheap labour and cheap capital – from abroad

We need to understand how we got into this mess and like Dorothy how to find our way back. Of course there is a world crisis but Gordon Brown has turned a global financial crisis into a British financial catastrophe. The first thing we need to get straight is that the financial crisis was not caused by sub prime lending in the United States. That has certainly been disastrous but it was a symptom and not a cause. Global imbalances and the lethal combination of very low interest rates and exceptional amounts of liquidity are the root cause. The Chinese were saving vast amounts accumulating around $3trillion of monetary reserves. Other countries like Singapore, Korea, Taiwan and the oil producing states did the same, whilst here in the UK and the USA we were on a spending binge financed by cheap borrowed money. The former Cabinet secretary Lord Butler put it brilliantly in a speech in the recent debate on the economy in the House of Lords when he said

> 'My view at the risk of offending both front benches, is that the prosperity of the past 15 years owes less to the brilliant management of Governments or the financial authorities than to an extraordinary combination of circumstances; we have had a supply of cheap manufactured goods from the Far East, a flow of cheap labour from Eastern European countries and an abundance of cheap credit … The trouble is that the prosperity has been built on major imbalances in the world economy. It has been built on consuming countries including the United States and the United Kingdom, consuming more than we were earning and living on the credit of the exporting countries'
> (Lords Hansard 7th May col 679).

### Warnings of 'Systemic collapse'

These imbalances have not gone away and just as banks like Northern Rock can collapse when their supply of credit vanishes so too can countries.

It is unusual for developing countries to be exporters rather than importers of capital. Against the background of a wall of cheap money Alan Greenspan cut interest rates whenever there was a market set back and Gordon Brown set an inflation target which excluded housing costs and created the conditions for an explosion in house prices funded by cheap mortgages. As an asset bubble developed with house prices growing by 25% in one year the Bank of England did nothing. Gordon Brown had taken away its responsibilities for macro prudential supervision and given them to the FSA who were too busy creating bureaucracy to see what was happening in individual banks like Northern Rock, let alone take a view on the overall financial picture. If this sounds like hindsight look at the debate on the Bank of England Act reported in Hansard of the 11th November 1997. The then shadow chancellor Peter Lilley warned (col 731) 'With the removal of banking control to the financial services authority … it is difficult to see how … the Bank remains, as it surely must, responsible for ensuring the liquidity of the banking system and preventing systemic collapse'.

That warning was ignored and now we are suffering the consequences. Gordon and Tony had decided the policy on the sofa without proper consultation with the late and much missed Eddie George. Just as he was once keen to take the credit for the boom so we used to hear a great deal about his reforms to the Bank of England and how, in the best traditions of Blue Peter, he had prepared them earlier and imposed them on a compliant Treasury, within days of winning the election.

### Bank Knights and 'Pass the Parcel'

At the heart of the UK banking crisis is a regulatory failure and a failure of monetary policy and Gordon Brown is the author. He wrecked the supervision of the banking system in our country and he encouraged the debt culture by boasting he had ended boom and bust. By removing the safety barriers he made a serious crash inevitable.

Of course now he leads the chorus vilifying the bankers but he was all over them once. James Crosby the CEO of HBOS, was made deputy chairman of the FSA, the body responsible for banking supervision, and

given a knighthood. Sir James was later asked to advise and report on sorting out the crisis in the housing market. He was ideally placed as HBOS went down with 40% of its loan book in property and with equity stakes in some of the companies the bank was lending money to.

The chairman of HBOS Dennis Stevenson was given a peerage and made Chairman of the House of Lords Appointments Commission. That's the body that decides if people are of sufficient calibre to make a regular and significant contribution to the Lords. Since his appointment a decade ago in 1999 Lord Stevenson has spoken three times in the chamber and I can find no record of him having ever voted.

Fred Goodwin was invited to advise Gordon on the New Deal and on credit unions. He was in and out of Downing Street and knighted for his services to banking. He now it seems has been appointed to the role of Prime Ministerial lightning conductor.

Alan Greenspan, the former Chairman of the Federal Reserve, who was responsible for cutting interest rates (the so-called Greenspan put) and for the monetary expansion, was showered with honours and appointed a senior adviser too. There have been some spectacular examples of greedy and irresponsible bankers but it is fatuous to put the systemic collapse of our financial systems down to just bankers and their greed. Some bonus systems undoubtedly encouraged short term, risky and even reckless behaviour and the regulator should penalise banks who refuse to reform their compensation arrangements by imposing higher capital requirements on them. But it is also worth remembering that a third of the shares in Lehman were owned by its employees who lost everything when it collapsed.

With low interest rates, pension funds and other investors wanted to find a higher return or yield and as everyone knows, high return equals high risk. Yields are inversely proportional to credit quality. So the cash sought out weaker credit. You can achieve that by finding weaker borrowers or by taking healthy borrowers and lending them so much that they become weak ones. Soon vast amounts were being lent and the loans sliced and diced and mixed together in complex products whose credit worthiness was assessed using computer models and complex probability theory. Because they provided an income stream at a relatively higher interest level they were attractive to investors seeking higher returns. The banks thought that as they no longer owned the loans they had eliminated the risk. In fact when the music stopped, in this foolish game of pass the parcel, it turned out that the banks had been selling these securities to each other.

## False confidence

I bought a new car a few years ago which had a satellite navigation system which I had read was amongst the best and most sophisticated on the market. My wife and I set off to spend the weekend with some friends in rural Norfolk using this new technology. My wife kept insisting it was taking us the wrong way. I believed in the technology and ignored her increasingly strident protestations even though the miles and time to destination readings were going up and not down. It was only after we passed the same level crossing for the second time that I abandoned the satnav, applied common sense, followed the road signs and we arrived safely at our destination. It turned out that the satnav had been incorrectly calibrated and thought we were in Holland. Garbage in garbage out. The regulators, the ratings agencies and the banks were all relying on models which were defective. Amazingly the non executive directors, auditors and highly paid managers had failed to do as my wife had done, which was use their common sense and question their systems.

Why? I think the Governor of the Bank, Mervyn King got it right when he said 'It is not easy to persuade people, especially those who are earning vast sums as a result, that what looks successful in the short run is actually highly risky in the long run'. The regulatory requirements which limited investment to products with appropriate ratings was intended to offer security but they turned out to be a Maginot Line which actually created false confidence and added to systemic weakness.

You cannot predict the future from the past and in any computer model the results are only as good as the data which goes in. It was like trying to drive your car by looking in the rear mirror. A crash was inevitable and when house prices started falling mortgage delinquencies and defaults started rising. The banks were not sure what was in the structured products they had bought, confidence vanished and no one wanted to buy any more. For banks like Northern Rock this meant they could no longer raise funds to lend and their business was over.

## Different this time – a 'Balance sheet' recession

Now we have entered a brutal recession which will add to mortgage and credit card default as people lose their jobs and incomes. It will be a slow and painful climb out of it. Banks are struggling to lend, despite huge injections of capital and liquidity, because they are trying to shrink themselves and existing borrowers are drawing down on existing facilities.

We have seen recessions before caused by inflation, followed by monetary tightening but this one is different. This is driven by plummeting asset values which have damaged the balance sheets of the financial sector, households and governments. We are all poorer than we thought we were and have to cut back.

Even now the Government doesn't seem to get it. You cannot solve a problem caused by excessive borrowing by borrowing more money. It is like applying for another credit card to pay off the others. In the end it makes things worse not better. It might buy you time, perhaps till after a general election but the pain and costs of addressing the problem will be greater.

The era of make do and mend is back. Incomes for most people have remained fairly steady over the last decade but many folk felt flush because they thought their homes and investments were worth more. It was an illusion. Now things have reversed and it will take years for confidence to recover.

### The road to recovery

So how do we get back to prosperity? By unleashing the enterprise, energy and talents of the British people. By encouraging growth and employment by removing the burdens of excessive red tape, waste and taxation. By living within our means as a country. By making the state our servant and not our master. By restoring faith in our institutions. By pulling together as a nation and as a United Kingdom.

## BRITISH BANKS AND THE CREDIT CRUNCH

*Extracts from a talk given by Angela Knight, Chief Executive, the British Banking Association, to members of the Economic Research Council on Tuesday 26th May 2009*

### A job description

I took over as the Chief Executive of the British Banks Association actually on April Fools' Day 2007 and there are a number of times to start a job, but may I suggest that if you are ever offered a job and it looks like it might be slightly tricky, pick January 1st as a better choice. But when I

was asked to do the job, Sir Peter Middleton, who was then the Chairman of Barclays and of course the Chairman of the BBA, said to me, 'What I want you to do is this. I want you to get banking off the back pages of the newspapers and put it on the front'. I don't think he quite meant it exactly as has transpired since then but I think I have perhaps more than anybody else fulfilled what was said to me to be my criteria for the job!

Today there is some greater stability within the banking industry than there was, say, a year ago. Yes of course there is still uncertainty because we do not yet know the full ramifications, the fall out of the credit crunch, we have volatility. But nevertheless what it is like today is orders of magnitude different to what it was a year ago.

**Warnings**

Prior to September 2007, the point at which Northern Rock hit the buffers, with everybody out on the streets and a run on a bank for the first time in a great many years in the UK, there were some thirteen events of significance which, one way or another, if not ignored certainly were not put together and looked at as a coherent whole. Let me give you some examples. The US's third largest sub-prime lender and their tenth overall largest lender both had filed for Chapter 11; Paribas had suspended three of its asset-backed security funds and the German authorities had had to rescue, not one bank, but actually two banks. Both the European Central Bank and the Federal Reserve were pumping extraordinary amounts of additional liquidity into their markets and yet Libor, as your Chairman has already mentioned, was continuing to rise. Now Libor comes under the auspices of the BBA and the sorts of calls that we were taking were: 'Libor was wrong'. Well the answer is: 'no it's not; no it wasn't'. What it was doing, perhaps almost more obviously than almost any of the other indicators, was indicating a huge stress in the money markets. And now, interestingly, what we see is people writing articles that say, oops, sorry, no, Libor wasn't wrong back then, that Libor was the forward indicator of the problems which we have subsequently had. But few at that time actually put all those events together. If they had, then maybe we could have avoided at least some of the worst of the problems that we have had both here in the UK and elsewhere. But you can never put back the clock. Actually after the Northern Rock, things were settling a bit; but it was when Lehman's failed on 15th September 2008 that the world's financial system froze.

## Globalisation

Now amongst the 'what was it that caused the problems' are a whole series of things which were largely outside the province of ability of the banks to affect: the global imbalances – the build-up of current account deficits in the West and surpluses in the East; credit was growing liberally around the world. We had an increasing balance-of-payments deficit in tangible goods here in the UK filled by the financial services industry. And because investors were wanting a better and higher return, we were being innovative, and innovation is what they got, and on the back of innovation comes, as we know, some consequences. Markets went up and up, a low inflation environment seemed to be sustainable, bubbles took place in energy and then in housing, and then everything came to a juddering halt.

## Consequences

And it tells us a number of things. The first of those is that, yes globalisation is a force for good, but it is not only a force for good, there are consequences. Certainly, the liberalisation of credit does bring broad benefits to companies and individuals but they are not necessarily sustainable broad benefits. It tells us that the only real monetary policy tool, which was to control by narrow inflation, is not actually the only one in town – things should have been broader than that. It also tells us that authorities who thought that you could let a bubble burst and then mop it up were, frankly, wrong. And the other one is that over the 9, 12, 15 years or so, capital rules have been changed, regulatory requirements have been changed, international accounting standards have been changed, and the assumption was that all that would cater for the New World. Fundamentally, each of those changes, meant that entities were simply not capable in many instances of meeting and surviving the turbulence. And the last thing, of course, is that actually there is such a thing as a boom and bust; to think that it had gone away was simply not correct.

So, the issues coupled with the assumptions presented a problem for the banking industry which is now an economy problem. People are angry. Financial services and banks have never been popular, even when they have been producing money for the tax payer, nobody has ever liked them. And right now we are the pariahs – we may have been temporarily overtaken by politicians but it is probably nip-and-tuck, maybe we should bring on the estate agents next. Either which way, what a lot of people are saying is quite right, that the cost of the intervention package is huge, jobs are

now being lost, our industry is in difficulty, UK is in recession; in some countries that anger has spilled out in the streets and I would say that in a number of European countries the true consequences have not yet been properly felt or properly acknowledged, or both, because the UK, as it always does, tends to go into things early, it does it in the spotlight, and I am a bit of an optimist – I have to be because I have a small pension and a big mortgage – I am a bit of an optimist, I think we do stand a chance of coming out of it at a reasonable pace as well.

I am well aware that some banks got things wrong, but not every bank got things wrong. I am well aware that with some their ability to manage risks was simply not good enough and for that the industry is not surprisingly deeply sorry. But the banks are responsible for banking; they are not responsible for regulation; they are not responsible for economic policy; they are not responsible for monetary policy; they are not responsible for fiscal policy either. There are a lot of people at the table, and it is only by accepting that that we will come out in the right sort of way.

## And the cost for banks

There is a price as well to pay for the interventions, a price in terms of what a bank pays if it uses the money market provided by the Bank of England. All central banks have had to provide additional money market facilities as the financial system is not working as well as it should, and some of you I am sure will have seen in the newspapers last week how much was the price of the money market as the Bank of England reported profits or surpluses or whatever the expression may be of just under £1 billion. That is money coming out of the banking sector which obviously goes back, not just to the Bank of England but also back to the tax payer. And the Bank of England facilities are significantly more expensive than similar facilities offered by the ECB which in turn are more expensive than that of the Fed.

We also, as part of the intervention package here in the UK, have offered to the Royal Bank of Scotland and the Halifax Bank of Scotland part of the Lloyds Group, what is known as an asset protection scheme, a means whereby it is possible to insure some asset portfolio. Why was that needed? Well, the answer is this. It is that the capital rules which were procyclical and not fit for purpose, coupled with the new accounting rules which required one to 'mark to market' assets held in the trading book, regardless of whether there was a market presence or not, resulted in a

significant downward spiral and one that was destructive. It was essential somehow to break that destructive downward spiral – whilst sorting out the accounting rules by the way, and also the capital ones as well. And have other countries done it? Well, let me give you two examples. France, actually, did not fully apply the international accounting standards. It did not 'mark to market' its trading book. Yes, they have a problem there, and indeed they have had significant government intervention. The problem is different because they used different rules. The price of their intervention is less than here. And Germany? Well, Germany is devising what it calls a 'bad bank', one in which you transfer assets from the good banks into the bad bank. Do you do it at market value? No, the proposition there is that you do it at the book value. And when do you actually value the assets? Well, somewhere between ten years and twenty years out. Right now, stability is essential but I think we have to keep a very clear eye on the fact that the cost of intervention will, as time moves forward from this difficult period, be very significant in looking at the long term competitiveness of the industry here compared with other countries.

## Four questions and answers

*(i) Why aren't banks lending?*

There are four questions that I am usually asked. So I am going to beat you all to it and ask and answer them myself. The first is, why is it that the banks aren't lending? To which I reply, they are, godammit, they are but the numbers look a bit different. The top line figure for finance in corporate Britain is £500 billion sterling. Of that, only £300 billion comes out of the main high street banks, that other £200 billion comes from overseas banks (I don't mean of the Icelandic variety, or, dare I say it, even the Irish variety) but all sorts of overseas banks who, whilst their leaders have been talking about the need to keep open markets have required repatriation of finance back to their home jurisdiction. That £200 billion capital has also been supplied by, for example, hedge funds, pension funds, and indeed from the non-banking sector in terms of, for example, the wholesale finance people. So that is a big gap that needs to be filled. And that is why on the one hand the finance and the banking industry in terms of the major banks in the UK is increasing but corporate Britain are still complaining about the gap. £200 billion cannot be filled very quickly. In personal lending the story is very similar. Some

18 months ago there were some 120 mortgage lenders; today there are the major high street banks plus perhaps two building societies. In fact over this last 18 months what we have seen is the majority – not all – but the majority of the building society sector unwinding its mortgage book and passing it to the major banks, as indeed has the Northern Rock and then there were the non-bank non-building society lenders as well. Up until recently the major banks have each month been remortgaging over 40,000 people and advancing another 26/27,000 mortgages. So that's why I say, yes we have been lending.

*(ii) Why don't we nationalise the banks?*

The second question is: why don't we nationalise the banks? Well frankly that would be completely daft. I come, as you have heard, from the north of England. I come from a world where steel was nationalised, gas was nationalised, water was nationalised, telephones were nationalised. I come from a world in which nationalised industries were bad performers, not good. Any sort of direct involvement with an industry by government should be temporary, it shouldn't be permanent, that is if you want to get the right result, and the right result is the best bank for the tax payer and the best service for the customer.

*(iii) Why not separate utility banking from investment banking?*

The third thing the people say is the banks are too big; break them up. Why should you have an investment bank, a casino attached to a simple deposit taker? Well, it is actually a pretty good headline, and underneath it is a very serious question which deserves a very serious answer. The US for many years had the Glass-Steagall Act which in effect did separate out investment banking from the other functions. Interestingly, when Glass-Steagall was repealed at the end of the 1990s a perhaps more important event took place which nobody talked about, and that was a reduction in capital the investment banks had to hold which then allowed them to expand their balance sheets. In fact, since then many more of the simple banks, the narrow banking, the savings and loans banks have got into difficulty than have the broad-based banks. And yes, when a broad-based bank gets into trouble it is pretty spectacular, but actually in one respect banking is no different than any other industry. If you've got a large range of customers and if you've got a variety of suppliers and you manage that business well, you are more likely to survive a difficult economic turn-down than if you've only a few suppliers and only a few customers, and you don't

manage it well. Good management probably lies at the bottom of the fall. So a return to Captain Mainwaring type banking is not actually proven to be the way forward by the current experience, and if we do either artificially constrain or break up our banks, then we would make it impossible to finance corporate Britain out of the UK.

*(iv) Should bankers take big pay?*
The fourth question people say to me is this: well, it's all about bonuses, it's greed, it's that big pay of the banking industry. And yes, there was some big pay – dead right – and there were some big profits made, big taxes paid, but there was some big pay and yes, some of the pay structures were not correct in the sense that they did not necessarily reinforce good behaviour; they could reinforce excessive risk taking here, in the US, and around the world, because we are talking predominantly about what happened with the trading book part of banks, and particularly the proprietary trading book part. That is an international business and that is where you can have an international problem. To think that the handful caused the problem for everybody is again not right, but there is a point there.

## The future

*(i) Reserves and regulations*
Now, where do we go? Well, evidently, we have got to change the capital rules so banks do hold more in the good times, save it up if you like for the bad times, just as we always used to do, before the advent of international accounting standards. In fact right now actually banks are holding twice the amount of capital that they are required to under the those standards. Secondly, what we have also found is that liquidity can completely disappear overnight. So obviously there will be requirements for those countries which are in fact the host rather than the home state, to require those banks that are operating in them to hold some more liquidity, some more cash, or cash look-alikes in future than was the case in the past. But we also need regulators to step up to the plate of holistic supervision rather than simply looking at execution of the rules and anybody who has been working in this industry for the last ten years will know that the concentration has been on the narrow execution of the rules in some areas rather than supervision of the entity.

*(ii) UK structures*

It is still not clear where the responsibilities do truly, ultimately fall between the FSA, the Bank of England and the Treasury. Yes, a Banking Act has been passed. Yes, the tripartite system is part of that. But let me put to you this point. If the Bank of England believes it needs to operate its money market, which is the supply of liquidity, in one way, and the others say require additional liquidity requirements in another way, who comes to the decision as to how those two requirements harmonise together?

*(iii) The EU*

And as we look at these things here in the UK, there are others looking at them too. The G20 of course is one, but Europe is another. The EU has already got many of these items on its agenda and the EU is proposing to lead, not follow. EU changes will cost money. They will all result in higher processing costs, higher operational costs and so higher prices of goods and services. And as we move forward, the UK, as it assesses these things, must focus very strongly on its position in the world because we very rarely in this country grow ourselves a world-class industry, but we have done it in financial services. So it is absolutely vital that the UK manages to influence Europe but we are at a difficult point in the political cycle. Search me what is going to happen past the European elections but there is a pretty fair chance that there will be a very disparate number and type of MEPs elected from the UK which means that their coherence of voice will not be good. We all know what is the view of many of the European countries of us – we are the ones that brought the problem and if we are in any doubt, Sarkozy said it out loud.

## Beware

So I am the first to admit that the industry does not get everything right, but it doesn't get everything wrong either. Yes, some banks lent too much money. Equally, some people and companies borrowed too much money and governments and regulators let it happen. But if we carry on with the demonisation of this industry, if we carry on with a holy grail of more regulation in every respect we will lose that world-class industry, we will diminish the size of our centre and we will not serve the UK and the UK people well.

# THE GROWTH CONUNDRUM

*By Robert McGarvey*

## The Rising Tide that Lifts All Boats?

The notion of 'a rising tide that lifts all boats[1]', popularized by John F. Kennedy, argues that economic growth – however accomplished – is by definition a social good, in that the benefits of economic growth eventually spread throughout all sectors and classes in society. Disturbingly, recent evidence seems to suggest that the fruits of economic growth are no longer 'lifting the boats' of middle and working class families. US government statistics indicate that from 1960 to 2005, GDP per capita more than doubled, while real median household income has essentially stagnated, rising only 15%[2] over the entire period. This trend, if it continues, could undermine public confidence; and not only in the linkage between economic growth and rising living standards, but in the capitalist system itself.

This potential loss of faith in economic growth as an engine of general prosperity is not simply a matter for economic policy makers, but strikes at the heart of our present economic theory. Management of a modern economy, the decisions and actions undertaken by politicians, senior economic advisors, Chairmen of the Federal Reserve Bank, business leaders and others, are derived from an underlying body of theory; today those theoretical underpinnings rest largely on the shoulders of neoclassical economics[3].

1 The phrase is associated with John F. Kennedy who utilized the expression in a speech delivered in October of 1963 to combat critics of his proposed tax cuts, but may in fact have been first employed by Irish Taoisigh Sean Lemass a few years earlier.

2 *Poverty in America: Trends and Explanations*, Hillary W. Hoynes, Marianne E. Page and Ann Huff Stevens, Journal of Economic Perspectives, October 2005

3 Neoclassical economics is not as unified a body of theory as is often implied. What is generally agreed amongst modern economists working within the neoclassical paradigm is the approach to economic analysis and the area of analysis – which is focused on market phenomena and the exchange process. Neoclassical economics concentrates on the determination of prices, outputs, and income distributions in the context of functional markets. Macroeconomics, although it deals with the large societal impacts of economic phenomena, is also neoclassical in its foundational assumptions. And it is true that new trends in economics are beginning to challenge the foundational structure of neoclassicism, introducing new humanistic and non-rational behavior into the realm of economic study.

Neoclassical economics (often referred to as the Marginalist School) has provided the theoretical foundation to economic policy for over a century. It is a system of economic thought concentrated on market exchange processes, focused on the determination of prices, outputs, and income distributions. Neoclassical principles include: utility based theories of value, a firm belief in market equilibrium and individualism (the proposition that all large scale economic problems can be explained by aggregating over the behaviour of individual agents).

The recent Financial Crisis and trends in wealth distribution are reinforcing the convictions of many that there are problems with our economic modelling[4], rooted in inadequacies in our economic theory[5]. Indeed a battle for more relevance and pragmatism in Economics[6] is already underway. This battle is not only being fought in the public arena, but is also spreading rapidly down the corridors of academia[7]. In the past few years petitions have begun circulating amongst undergraduate students (and that most conservative constituency, post graduate students in Economics), seeking to broaden the study of economics: to make it more 'real'.

## So what difference does all this make?

Because of its narrow focus on the exchange process, neoclassical economics has not developed a theory of asset evolution (and a true structure of 'incentives' in the economy) or a clear understanding of the impact of asset ownership on the overall distribution of wealth in the capitalist system. As a consequence conventional economics is struggling; important changes in the nature of production in an emerging knowledge economy

4 *Understanding Economic Forecasts*, Edited by David F. Hendry, and Neil R. Ericsson, Historically, the theory of forecasting that underpinned actual practice in economics has been based on two key assumptions that the model was a good representation of the economy and that the structure of the economy would remain relatively unchanged. In reality, forecast models are mis-specified, the economy is subject to unanticipated shifts, and the failure to make accurate predictions is relatively common.

5 *Monetary Macroeconomics, A New Approach*, Alvaro Cencini, Routledge International Studies in Money and Banking.

6 *Back to the future, Discovering the importance of the Austrian Economics as minor literature*, Matthew Hisrich, Senior Policy Fellow, The Flint Hills Centre for Public Policy, Wichita KS, USA.

7 Colander, David. *The Lost Art of Economics: Essays on Economics and the Economics Profession,* Cheltenham, UK, Edward Edgar, 2001.

in combination with the profound impact of globalization continue to challenge traditional economic modeling which in large measure continues to be based on 'factory-type' industrial production taking place in isolated national economies.

Fundamental changes in the underlying structure of the global economy are challenging economists, but have also created distortions in official government statistics, according to Michael Mandel, Chief Economist of Business Week: *'traditional methods used by the federal government to measure the economy's performance are largely obsolete due to the nation's ongoing transition from an industrial economy to one that is primarily knowledge-based'.* [8]

According to a 2005 University of Maryland study, when intangibles are added to the statistical mix, the asset revolution is having dramatic impact: consider capital deepening, the economist's measure of capital efficiency. In the period 1973–1995 the efficiency of capital as a measure of capital stock per labour hour was 0.43, the equivalent figure for the period 1995–2003 is 0.84. In other words, the rise of the knowledge economy has translated into (approximately) *a doubling in the efficiency of capital*. The impact of the knowledge revolution on labour productivity is equally impressive. The average productivity per worker in the United States as a measure of output per hour has jumped from 1.36 (1973–1995) to 2.78 (1995–2003), put another way *productivity per worker has more than doubled*.

Unfortunately the full extent of new investment and value creation is masked by existing metrics and institutional practices, particularly GDP calculations and accounting practices both of which exclude the intangible component of this new asset capital. According to recent studies, undocumented intangible investment in the US economy in 2003 amounted to over $1.2 trillion, while the capital value of intangible asset growth in 2003 alone amounted to US$3.6 trillion (11.7% of US GDP). The statistical discrepancy is a whopping 52%[9].

In other words if intangible assets were factored into conventional data the US domestic savings rate, far from being negative, is actually positive. The US trade deficit with the rest of the world becomes much smaller than advertised, and US *GDP is growing faster than the latest gloomy numbers suggest.*[10]

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8 http://www.businessweek.com/magazine/content/06_07/b3971001.htm

9 Intangible Capital and Economic Growth, Carol Corrado, Charles Hulten, and Daniel Sichel, December 2005

10 http://www.businessweek.com/magazine/content/06_07/b3971001.htm

## Drowning in the Rising Tide

So, does a rising tide still '*lift all boats*'? Unfortunately there is growing evidence that the answer is no, at least not lately.

Conventional wisdom in central banking circles seems to be that throughout the Greenspan era inflation was kept well under control, the Federal Reserve Bank had largely met its objectives. The question is, did it?

There is little doubt that by the modern CPI definition inflation was controlled, prices were and remain relatively stable (staying within acceptable bounds). But if we revisit the data from a more traditional monetary growth viewpoint, incorporating broad money categories including all the sophisticated derivatives/debt instruments that were created over the past decade the answer is not so clear, at least officially. Unofficially, the market has made up its mind; conventional wisdom on the street suggests that deflation, the 'Great Unravelling' still has a considerable distance to go.

But, what if the rise of knowledge assets in the economy means we are measuring the wrong things and consequently underestimating GDP growth, what then? Perhaps this debt/derivative mountain is not simply cantilevered out over a vacant abyss, maybe – just maybe – it's supported (more or less) by undocumented intangible asset growth.

Well, if we are experiencing stronger than measured growth, the economy should be generating surplus value. If it exists, this surplus value is not being reflected in higher prices, which are well managed by present monetary policy and the forces of globalization. And surplus value is certainly not heading in the direction of wages, which have been largely stagnant. No if growth in GDP is larger than we're measuring the value must be going somewhere – indeed there is increasing evidence that until recently it was going in the only direction left open to it, fuelling the massive inflation in asset prices. Today it is simply accumulating in cash or cash equivalents.

So, what's the problem? Well, there is evidence to suggest that (1) problems with our foundational economic theory which is so narrowly focused on the exchange processes that it is at a loss to explain the impact of a transforming asset foundation in our modern economy (which is contributing to miscalculations in the measurement of growth in GDP amongst many other ills) and (2) various erroneous assumptions at the highest level in our monetary policy are dangerously skewing the distribution of wealth in the economy.

The facts point to diverging futures for our citizens. When the statistical mask is finally pulled away and markets return to normal, the economic

surprise *de jour* will be the near 'miraculous' recovery of the US and other western developed economies. Then we'll all swiftly discover the sources of real value growth, powering recovery and above average returns. All of which is very good news for the fortunate few who own assets (new or otherwise), property, stocks, or other business interests, for when the tide rolls back in it will definitely be '*raising your boat*'… considerably.

On the other hand, if you're one of the growing army (largely youth) who do not own property (or can't afford to get on the property ladder), and have no other assets to speak of, this rising tide will NOT lift your boat … it will drown you, slowly but surely. Like the Ancient Mariner, there's liquidity, liquidity everywhere, but if you've a wage earning family that has slipped out of the property owning middle-classes there will be '*nary a drop to drink*'.

## MID MORNING AFTER THE HANGOVER

*By Damon de Laszlo*

The summer months have slid by without any new major economic mishaps. Stock Markets drifted higher and the statistical recovery started to appear. That is the rate of decline year on year flattened out giving a warm impression that the end of the crisis was at hand.

September and the return to work has brought a little reality back into the Stock Markets which are likely to be confused over the next month or so as everyone waits to see what the autumn brings. While the US economy has stabilised and Government stimuli begin to take hold we are seeing both a real and statistical upward movement in the economy; however real GDP growth is unlikely. Private sector borrowing, which was adding 1-2% to US GDP over the last 4 to 5 years, is now quite naturally turning into savings to pay down debt. These savings must produce a very considerable drag on US GDP growth. The good news is that the US will import much less and its balance of trade will improve. The savings in the short term will help considerably towards funding the Government and State deficits. The US business sector reacted exceptionally rapidly to the economic downturn with the result that the majority of US industry has

cut its borrowing requirements and maintained productivity to a remarkable extent. All this sets the stage for an improvement in the Government's revenue from corporate taxation, a rising stock market over the next few months but little comfort on the employment front. The 2 icebergs, clearly visible in the economic sea, are the Government deficit, how fast will it melt away, and the huge liquidity bubble that the Fed has pumped into the system which could turn into inflation if it is not reabsorbed.

China, a country whose economic management should be a case study for all central banks and finance ministers, seems to be reducing Government stimulus in order to prevent an asset price bubble developing. The Government's effort to redirect the economy from export led growth to internal growth is gaining momentum. Chinese Government initiatives to collaborate with Taiwan and Japan are particularly pragmatic. The same drive to work with India is more difficult owing to political tensions along the Himalayan border and potential conflicts over water which is in short supply on both sides of the mountain range. China's efforts to redirect its economy will have considerable impact on the prospects for inflation in the West. The supply of consumer goods to the Western market, which has been a major contributor to lowering the price of goods over the last 5 years or so, is declining.

South America and Australia did not fully participate in the economic boom that was driven by the borrowing of the Anglo-Saxon world, prospering as with China. However they continue to prosper as China and the other Asian countries stabilise and increase their imports of food and raw materials. Europe, on the other hand, is suffering with its Governments of economic ostriches. Germany, unlike China, plans to continue promoting its lopsided economy by favouring exports over internal growth, ignoring its massive internal imbalances. The Mediterranean countries continue to hide within the € currency their massive Government deficits leaving France in the middle pursuing its own, and I have to say, pretty successful brand of state sponsored corporate socialism. Britain remains the oddest animal in the Zoo. Its unfundable Government deficits, without the protection of being in the €, could at any moment collapse Sterling and ignite inflation. We will, as a country, have to wait and hold our breath until after the next election before there is a chance that a coherent economic policy can appear.

In general we go into the autumn with an improving global economic picture but with the worry that the pain after the party of the last 5 years is going to be felt by the most vulnerable parts of society. Unemployment is likely to be the biggest social problem in the aftermath of the boom years.

## ARTHUR SELDON *and* THE ROTTEN STATE OF BRITAIN

*Arthur Seldon: A Life for Liberty*
by Colin Robinson, Profile Books, 2009 h/b £19.99

*The Rotten State of Britain: Who is Causing the Crisis and How to Solve it*
by Eamonn Butler. Gibson Square, 2009 h/b £11.99 p/b forthcoming

Arthur Seldon (with Ralph Harris) developed the Institute for Economic Affairs (IEA) from the days of its founding by Anthony Fisher in the 1950s through to his retirement 30 years later. Colin Robinson's biography is a delightful account of the man who was for so long the powerhouse of ideas and the inspiration for writers which resulted in that quite extraordinary outpouring of thought-through policy ideas expressed in publications advocating market based solutions for the supply of a huge range of goods and services.

His philosophy was essentially that of Smith, Mill, Hayek and the 'liberal' side of the London School of Economics. In effect, the IEA has carried forward the free trade, small government platform of the 19th century Liberal party – even though the modern Lib-Dem party in Parliament seems long ago to have deserted that agenda which, a century ago, won them overwhelming victory after overwhelming victory at the polls. One writer – George Dangerfield – famously described that desertion as 'The Strange Death of Liberal England' in a book published in 1935. He was not then to know that a flame remained alight that would later flourish at the IEA.

This book is a pleasure and one might almost say, an adventure, to read. And it has been well and widely reviewed in far greater detail than is possible here. Suffice to say that Arthur Seldon grew up in a poor urban community where neighbours and friends at a local level gave help to those who needed a helping hand but where effort and competition was the proven way forward. There was little trust in 'the man from Whitehall' who sought to replace this budding spontaneous wealth creation with state monopolies. Seldon sought for – and found – endless ways in which competition could be nurtured. Privatisation, the dismantling of restrictive practices and the exposure of humbug from 'market failure' to 'incomes policies' are all part of our intellectual inheritance owing much to his work.

But still. In a sense we can talk of failure. The collectivist Labour party and the paternalist Conservative party have landed us now with a state sector still larger than anything that existed before 1939. Now, elections are fought between the 'claimant class' (which votes for whoever promises the most) and the 'frustrated class' (which is disillusioned with all parties). The efficiency gains which Seldon so successfully promoted seem outweighed by political events and developments.

Events and developments described vividly in Eamonn Butler's 'The Rotten State of Britain. It is a useful coincidence that this book has appeared at the same moment as the biography of Arthur Seldon. Both books are based on the true liberal spirit but whereas Seldon, working in the 1960s, 70s and 80s chose to focus his attention on economic issues – promoting the virtues of open business practices within a framework of law, custom and goodwill rather than official provision or regulation, Butler, working at the Adam Smith Institute (ASI) in the 1990s and 2000s has been obliged to focus on the results of our political arrangements.

Entertainingly, Butler's book is almost a parody of an Agatha Christie 'Whodunnit?'. We begin at the scene of the crime – Britain in a (yet more) rotten state, the economy in crisis, a government of spin doctoring charlatans. Britain's reputation abroad is in tatters, politicians have become corrupt, justice has been perverted and the population is enfeebled by regulation, fear and state snoopers monitoring every move. It is, if we are prepared to face up to it, a truly shocking state of affairs. This generation – our generation – has betrayed the hard won gains of a millennium. Colin Robinson subtitled Arthur Seldon's biography 'A Life for Liberty'. The crime is that so much liberty has been murdered.

Agatha Christie, or anyway Eamonn Butler, then takes us through subject after subject building up the events and facts of the case. At no point before the final chapter does he tell us just who is to blame. The reader is left to speculate which of the *dramatis personae* has committed the crime? Is it the Capitalists? Is it the Socialists? Is it Democracy? Is it State Monopolies? Is it the European Union? Is it a Dark and Hidden Conspiracy? Is it The City? Is it Political Institutions? Is it Human Nature? Is it The Americans? Is it none of the above but some previously undetected force which Butler will conjure with a flourish out of the mouth of Poirot?

I told Eamonn that I found most of his book depressing – just too much badness to take in at one time. He took my point and said 'Yep – it's a rant'. But it is fair punishment and when one gets to the chapters on Health, Education, and Welfare policies one is in tears – but tears mixed

with the pleasure of being reminded of so many of the warnings that Arthur Seldon made when things were at an earlier stage of decay.

And so to the final denouement. Via the underlying realms of 'Society' and 'Values' (chapters 13 and 14) Butler reaches the finale, chapter 15 'Stopping the Rot'. Everything has been assembled – the suspects, the evidence, the arguments, the history, the subject matter. We are now to listen to Poirot. Silence falls.

It is, he says, not individual policies or philosophies or manipulators that are at fault, but rather, our unreformed political institutions and constitutional arrangements. We must not let our eyes glaze over – this is seriously interesting! I have not seen such an understandable and convincing case made before for (for example) paying all MPs the same salary whether they are Ministers or not, for having term limits on MPs, for having a new Bill of Rights, for having a fully elected House of Lords. I had never before thought about devolving to English counties the same powers as those currently given to devolved Scotland and Wales or allowing Parliament rather than the Prime Minister to appoint judges, diplomats, bishops and quango members. Police powers should be devolved, the creation of new regulations set in an institutional framework, schools set free and welfare reshaped to encourage participation rather than dependence. 'Ridiculous!' shout the guilty. Ah no, mon ami.

Butler concludes 'We need action to restrain our leaders … to disperse power, where possible … back to ourselves, the people'.

Both books are highly recommended.

J.B.

# CURMUDGEONLY SCURRILITY

*Two poetic contributions dated February 2008 and February 2009 from disenchanted Economic Research Council member John O'Donnell.*

*10th February 2008.*

## The Poodle and the Plod

My name is Blair the poodle,
And mine is Brown the plod,
We speak as if we're doing you proud,
And be seen to talk with God.

If you can give us money bags,
Then honours we'll bestow,
O sure we've wrecked the House of Lords,
And parliamentary democracy also had to go.

We went to war without good cause,
And thousands now are dead,
We tried to show we took care,
But lied to you instead.

Dr Kelly by his tragic death,
Keeps focus on the shame,
For a forty five minute warning damned,
With Blair and Brown to blame.

All change all change we've made mistakes,
Like gold we've sold or pensions raided,
How dare you mention our mistakes,
Like Britain's EU rights downgraded.

And yet as public servants paid,
By you to work and serve,
The Secrets of Information Act we've passed,
Should apply to us! You've got a nerve.

The word of Labour with its spin,
Stood empty like the Dome,
Who could believe a word that's said,
With Blair or Brown at home.

The London "Signal Failure System",
The shame of London town,
A reminder of Labour's insincerity,
In letting people down.

Labour's manifesto, referendum promise,
To the British, honour bound,
But honesty to Labour seems so profane,
That it's ignored by "Haggis Brown".

The Heathrow Airport expansion scandal,
The no third runway Labour pledge,
Another lie Mr Brown must sigh,
Like the bonfire of the quangos' pledge.

The CPI, prudent Labour's boast,
Inflation we've dutifully controlled,
Now the tragedy of the housing burst,
Is due to excluding asset prices of course.

Blair for war crimes must be tried,
To ease Britain's troubled soul,
The nation's pride so sadly died,
With that poodle in control.

No confidence in the organs of state,
And more bureaucracy and less respect,
What a legacy we've been sold,
By Blair and Brown's neglect.

The Monarchy, the only thread,
To unite Britain's fractured soul,
The greatness of the past is tarnished,
Now three nations, not the whole.

*28th February 2009.*

**Haggis Brown**

Old haggis Brown the Scottish clown,
Has let dear old England badly down,
He talks as if he's not to blame,
Such dishonesty becomes his shame.
Failure is his stock in trade,
How many bad mistakes he's made?
Global is the word he uses,
In hope the electorate he confuses,
Pensions, gold to "boom and bust",
While those that know just feel disgust,
For domestic problems are the cause,
Yet on the foreign stage he seeks applause,
Gonker Brown has done such harm,
A man devoid of any charm,
As UK Prime Minister and unelected,
But on performance it is expected,
As who would vote for such as Brown,
That has let both Queen and country down.

APPLICATION FORM

To the Honorary Secretary
Economic Research Council
Baker Tilly
65 Kingsway
LONDON WC2B 6TD

Date......................................

APPLICATION FOR MEMBERSHIP

I am/We are in sympathy with the objects of the Economic Research Council and hereby apply for membership.

| This application is for<br>*(delete those non-applicable)* | Individual membership (£35 per year)<br>Associate membership (£20 per year)<br>Student membership (£15 per year) |
|---|---|

NAME......................................................................................................................

ADDRESS..................................................................................................................

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.................................................................... TEL. ......................................................

EMAIL ....................................................................................................................

PROFESSION OR BUSINESS ....................................................................................

REMITTANCE HEREWITH.......................................................................................

SIGNATURE OF APPLICANT ....................................................................................

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

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

## BENEFITS

Members are entitled to attend, with guests, normally 6 to 8 talks and discussions a year in London, at no additional cost, with the option of dining beforehand (for which a charge is made). Members receive the journal 'Britain and Overseas' and Occasional Papers. Members may submit papers for consideration with a view to issue as Occasional Papers. The Council runs study-lectures and publishes pamphlets, for both of which a small charge is made. From time to time the Council carries out research projects.

## SUBSCRIPTION RATES

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Associate members ................ £20 per year (Associate members do not receive Occasional Papers or the journal 'Britain and Overseas').

Student members ................... £15 per year

## APPLICATION

Prospective members should send application forms, supported by the proposing member or members to the Honorary Secretary. Applications are considered at each meeting of the Executive Committee.

## NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

## OBJECTS

i) To promote education in the science of economics with particular reference to monetary practice.
ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.
iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.
iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.
v) To publish reports and other documents embodying the results of study and research.
vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.
vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.