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

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AN ALTERNATIVE VIEW ON HANDLING THE BANKING CRISIS

A talk given by John Redwood MP, Chairman of the 2006 Conservative Economic Competitiveness Group, to members of the Economic Research Council on Tuesday 1st September 2009

Our extraordinary banking events

I do have a rather different view of why we are where we are, a view that I have built up over the last five years watching the extraordinary events that have been unfolding and the often even more extraordinary policy responses to those events, and I would just like to assure you that this is not someone jogging backwards who is suddenly blessed with a little bit of 20:20 hindsight; these views I developed over the five years of the running crisis so far and I have set them out day by day on my website johnredwood.com, so if anyone of you has ever looked at that there will be some familiarity with the analysis and views I now want to share with you. My disagreement with the consensus revolves around several consensual propositions in the media and academic commentary on the crisis so far and particularly with the explanations often emanating from the Treasury in Downing Street.

Our crisis wasn't 'made in Wall Street'

The *first* explanation that this is a financial crisis made in Wall Street and in America, that Britain somehow was a bit of a sideshow, that we got caught in the wash from the American crisis and that we were in a rather good position because we didn't have the full force of the American crisis I think now is generally agreed to be nonsense. If anybody stood up for that I would say two words to you – 'Northern' and 'Rock'. Northern Rock it seems to me was a British bank lending mortgages to British people under the regulatory system of a British regulator – the FSA – and operating to some extent, and when it came to it, to a greater extent, in the money markets presided over by the Bank of England, so here was a British bank under British regulatory control, not in any way caught up with American sub-prime, which came to a premature and sticky end before it was nationalised.

It hasn't been a case of 'good government' saving us from 'bad bankers'

The *second* consensual view that I disagree with is that we should be eternally grateful to leading governments, and particularly to the US and UK authorities and administrations for saving the banks from disaster in the late autumn of last year, and this explanation assumes that the central banks, authorities and governments have somehow put everything right and had been benign up to that point, they were faced with this problem created by evil, wicked or incompetent, stupid bankers and out of their manifold mercy and their wish to avoid the worst economic catastrophe they valiantly stepped in with taxpayers' money and all sorts of other policies and saved the world from disaster. As I hope to illustrate by my commentary and analysis – shortened as it will have to be this evening – I don't see it like that.

Do I believe that some bankers got it hopelessly wrong? Yes of course I do. Do I believe that chairmen and chief executives of large banks who have made too many acquisitions, extended too many loans, took too many risks and lent too much, should come to a financial sticky end themselves? Yes of course, that would be very desirable; I think they should be removed from office. I do not think they should get their bonus payments. I think there should be some kind of financial retribution. I don't think they should be bailed out and paid bonus payments by the taxpayer, but nor do I think that wicked or bad bankers is a necessarily sufficient explanation for what happened, and I want to demonstrate this evening briefly that a lot of the problem was created by bad regulation and by boom-and-bust monetary policies on both sides of the Atlantic.

It hasn't been just one 'short' crisis

And the *third* explanation which I don't agree with, which is a consensual view, is that we have just had one short crisis – a crisis of over-lending through wicked banks and central authorities manoeuvring to try and tackle that very difficult crisis. My view is that we have had three crises or rather three long drawn-out phases of a huge crisis, that we have had three phases that have followed each other in succession, and that the actions of the authorities at every stage certainly made the problems and crises considerably worse and arguably were the main cause in each case of the nature of the crisis that we had at that time.

Three phases of a long crisis

i) Boom

So the first phase was the boom phase and this really can be dated from the early noughties; it started gently and perhaps defensively but by 2007 we were well into overdrive on boom, boom, boom, and the monetary policy background to this is very clear. On both sides of the Atlantic the monetary authorities kept interest rates very low for much of that time period because they didn't believe the recovery was for real, or they didn't believe the recovery was strong enough, or they believed that the economy can take more stimulus because they are driving the car just looking at the inflation indicator, which is a kind of rear view mirror; there is nothing in the rear view mirror, the road is still clear, so they carry on accelerating, not seeing the potential crash ahead. So we had this long build up where the monetary authorities decided on very low interest rates.

Now there is a UK variant to this which I think is quite important when trying to look at who did what, when, and it wasn't just the Bank of England that got monetary policy wrong in the early noughties, they were sent very strong signals by the government that they should get it wrong. I think the most important signal sent was when the then Chancellor of the Exchequer changed the target for inflation at a rather crucial time. Now, why did he do that? He said he did it because other countries were using the CPI. He said he did it because that well-known Euro-sceptic Gordon Brown suddenly had a rush of Euro-enthusiasm to the head and decided we needed to harmonise with Europe. I didn't regard it as a European issue; I regarded it as a bad management issue. It seemed to me that the last thing you wanted to do, when arguably money growth was speeding up quite a bit, when arguably credit was building quite a bit, as could be seen even then, the last thing you wanted to do was to change targets in a way which sent a clear signal to the Bank of England to keep interest rates lower for longer. That was what the change of target did. In those days, very consistently, year after year, the CPI was under-performing the Retail Price Index and it was under-performing the Retail Price Index by more than the adjustment which Gordon Brown correctly made – he recognised that there was a difference between the two indices when he set the new target, and I think he knew that only too well as he is a clever and wonderful man on these things – I think he knew that the adjustment was not the full amount of the differential between the two rates but it suited him because it sent a signal to the Monetary Policy Committee that

they needed to keep rates down for longer. The last thing the government wanted was nastily rising rates 2003–05. The Chancellor couldn't have been quite clear when the election was going to be but he probably thought it might be around early 2005 and he wanted to keep rates down, and that was a good way of doing it. In America they were going through a similar kind of thought process about the need to keep rates low.

Why did they think it was going to work? I think the mistake they were making was in their view of inflation. They thought it was fine because retail price inflation was quite low and it didn't seem to be going up very much despite the huge monetary stimulus. The reason? Well, the Chinese, Indians and others, particularly in Asia but throughout the emerging world economies, were creating huge quantities of new capacity and they were bringing vast armies of the people off the land into industrial work and they were creating huge new factories, partly with Western technical assistance, but who soon became self-generating and financeable out of the enormous surpluses they were making, and so we had the phenomenon that they were able to flood the world market with increasingly good quality, very cheap products, which kept goods prices down, which had a good dampening effect on the overall CPI.

But there were many other warning signs if you were serious about inflation; most notably asset prices, and then in the late stages of the boom, commodity prices. Most of the excess credit and money, particularly in the UK and to a certain extent in the US, went into property transactions and into raising property values. The same thing happened in Spain, the same thing happened in Ireland and we saw these phenomenal booms, and the central banks said, it doesn't matter, that's an asset price, we are interested in retail inflation, price inflation or consumer price inflation, all is well, the rear view is clear in the mirror so we will speed the car up.

So I think you have to say that there were huge policy errors in many places in 2002, 2003 through to 2006, 2007.

ii) Slam on the brakes

We then in 2006/2007 onwards went into the *second phase* of the crisis when suddenly the authorities think that maybe there is something to the doom mongers arguing very strongly that there is too much asset price inflation around and that this could spill over into service inflation or even into goods inflation. It got to the point where even the Indian and Chinese capacity was pretty fully used, and they saw the opportunity to up their margins a bit and to offer less exciting prices; they were having quite a lot

of wage inflation in India and China, very low wage economies, they wanted to come to the party, why shouldn't they, they were extremely good, they were working very hard, so we started to see some inflation coming in from Asia as well. So the authorities saw there was after all a possible crash on the road and decided to jam on the brakes. So they put on the monetary brakes, not just by putting up interest rates. If you look at the charts of interest rates, the changes by the standards of the previous thirty years are not enormous but if you look at them as percentages of the original interest rate base, they were very big. So if you had taken out quite a big loan at 2% and suddenly you were faced with 4%, you had a doubling of your interest on a loan you couldn't afford. It was extremely uncomfortable for those in that kind of position, but the authorities thought we needed to send a very clear message.

But more importantly I think, especially in the United Kingdom, by the summer of 2007 they decided to double or treble the bet to bring the house down by allowing the markets to drain of liquidity. I can remember some of us in the summer of 2007 shouting at the Bank of England in Britain through our websites or on the BBC on those rare occasions when they thought the alternative view had any merit, to get the markets more liquid because they were going to bring banks down, and we didn't blame banks because we didn't want to be the story and to help cause the problem, but the market operators in London in July and August of '07 knew only too well that the three mortgage banks – Bradford & Bingley, Alliance & Leicester, and Northern Rock especially – were pretty exposed and that if the money market stayed too tight for too long they would be in considerable difficulties. And then people even started whispering that a big bank like RBS could also be a little distressed if things did not improve.

But the authorities ignored all that. They carried on with their ultra-tight money policies and they refused to cut interest rates throughout 2007, and in that phase of the crisis in Britain we had the dry run for the big crisis that happened exactly a year later with the Northern Rock disaster, but the authorities didn't seem to learn from it or to use the time that the rather botched Northern Rock rescue bought them. Just before the run on the Rock, you may recall that both the Chancellor of the Exchequer and the Governor of the Bank of England, made important speeches in which they lectured banks and said, 'some of you banks have written some very foolish business, you probably lent too much to the wrong people, it shows how careless you are – do not expect us to bail you out. We believe in something called moral hazard. You placed your bet; you must pay out

when you have lost'. Or 'you have made your bed; you must now lie on it'. Within 48 hours of the Chancellor's most dramatic version of his moral hazard speech, they did a complete U-turn and were forced to guarantee all the deposits in Northern Rock because the government was faced with the awful situation that the one bank from the north of England that they treasured, the one bank that seemed to have proved you could create a big financial services giant in the north, the one bank which had done quite a lot to advance more home loans to people in the north-east, that they too could enjoy the very genuine pleasures and benefits of home ownership, was the one that hit the crisis first, so it was the worst possible bank from their point of view, so we saw the U-turn.

It was the missing summer when the Chancellor was on the beach or he was in Edinburgh when he was meant to be the Chairman of the tri-partite grouping, when you would have thought the tri-partite grouping would have been meeting formal meetings once every week throughout July and August, given the rumours that were circulating, and you would have thought they would have been on the phone to each other on an even more regular basis. But no, apparently not, they were very blasé about it all, they didn't see it coming, and they had to do this rather difficult U-turn, offer the guarantee, and then, quite extraordinarily I thought, offer to do a major bail-out.

What should they have done? Well, I was urging them in the summer to make the money markets more liquid. If they had made the money markets more liquid, Northern Rock could have borrowed a bit more on a short-term basis to keep it going, and it would have been under clear threat from the markets to sort itself out. The Regulator should have got on the phone privately to Northern Rock and said, you are over-extended, securitise some more, sell something off, cut your costs, do whatever it takes, I don't mind how you do it, but there is not going to be a lot of money available for you, just get it sorted. But they didn't do that, they allowed the thing to drift dangerously and then did the extraordinary U-turn.

If that hadn't worked, what would you have done? Well, what I would have done is I would have said to the Bank of England, you are the lender of last resort, a perfectly honourable function. It is very clear a bank's last resort is financing; but that bank needed first resort financing as well, as it turned out. But why not do it through the lender of last resort facility? What are the advantages? One, you are not the equity owner so you don't have to take all the hits. Two, you can do it on short term with very tight monitoring. Three, you are buying them a bit of time if they did have other

options to try and cut costs, to get rid of risks, to try and push some of the risks round the market and so forth. They were a relatively small bank, it could have been fixed with a delayed market solution with a lender of last resort activity, but for some reason best known to themselves, they tried a different kind of clumsy, rather public sale offer of the bank and no-one was going to take it on because they could see they could get it cheaper by letting it dangle, and after a bit they gave up and decided to buy it for the state instead. They then of course didn't know what to do with it, under pressure from some of us who were saying that this is a difficult set of assets for the taxpayer to own, just wind it down and manage it, get rid of the administration, cut the risks as quickly as you can. They started off on that policy, then they realised that meant no more mortgage business, it meant cutting staff, it meant closing branches. That then didn't appeal to them, having started on that course, so they turned round and said they wanted it to be their public sector mortgage bank after all. I think it must be very difficult to run something when the rules and the aims change so dramatically within the first year of its new ownership, and it didn't make life easy. But they wasted a year; they messed around with Northern Rock in this way and they didn't take the threats to the bigger banks seriously.

And so we came to the autumn of 2008. There had been a cacophony from those of a more sceptical or more worried turn of mind saying there are big banks in trouble as well as small banks. Again, what should they have done? Well, what any sensible Regulator would have done at the end of 2007, having seen the Rock disaster and having heard about the problems of Bradford & Bingley and Alliance & Leicester, surely the Regulator would have got on the phone to RBS and HBOS (not then Lloyds) and said, we have reason to believe you have got some difficulties too; we are very glad you are not in the straits of Northern Rock, please make sure you don't go there. We the Regulator, privately want to see your plans for raising your capital, cutting your costs, raising your profit margin, selling off assets, whatever it is you are going to do, because we want you in a year's time to be a stronger bank. We are not going to make any of this public; we are not going to worry people. This is a private conversation, Regulator to Chief Executive, or Regulator to Chairman, but do it and come back to us with regular reports. I remember having to do this when I was Insurance Regulator in the early 90s when the insurance industry was in difficulties; nobody ever knew what I was doing apart from the chairmen and chief executives of insurance companies, but we saw them all through. They were short of capital and they had quite a lot of risks,

but we managed it through with them. They managed it primarily but we gave them the initiative. We, the Regulators, said to them, we can't put up with this so sort it, and they did. They will do that and they have flexibility if it's not done in public. But the authorities didn't tell the big banks to sort themselves out.

Then extraordinarily, they decided towards the end of 2008 to suddenly say, Oh my God, these banks haven't got enough capital, Oh my God, they haven't got enough cash! (Well, what's news Regulator? We have been telling you that for years.) And we are now going to demand that they have it. Not merely are we going to demand that they have more cash and capital, we are going to do it in public! Oh wonderful! What better way to undermine confidence in the UK banking system than to have the Banking Regulator saying to the leading banks, we don't think you've got enough capital, we are going to call you in for the weekend, because the markets aren't trading, and we are going to not let you out until you have got something to say to the markets. And of course they said that would solve the problem. But I think it made the problem hugely worse because it showed that the Regulators were at last very alarmed, the time pressures on the banks were impossible by that stage, having wasted a year, and of course once the markets were alerted to the Regulator's fears, the price of raising the money in the private sector greatly increased because the perception of risk had increased if the Regulator says he is not happy with the banks' position. The Regulators again compounded the error even further by encouraging or allowing the merger of HBOS with Lloyds. In my view Lloyds was OK. I don't think it was too over-extended. I think it could have raised a bit of money in due course on its own account in the normal course of things, or it could have sold a few assets or cut its costs a bit. They could have done it without any of this hysteria and access to the state. But unfortunately the Lloyds top management rather liked the idea of expansion, even at this very dangerous late stage in the cycle, even when it's HBOS. The government seemed to encourage them, telling the Competition Regulator not to call them in and say this is an anti-competitive merger. The Banking Regulator doesn't call them in and say, if you add a bad bank to an alright bank you don't end up with a good bank, but you can end up with a bigger bad bank. But that is exactly what they decided to do and we then had the spectacle of not just of RBS as a result of the Regulator intervention needing special measures but also recently merging Lloyds/HBOS and I was one of those who consistently opposed the Lloyds/HBOS merger and always thought that the ABM-Amro merger

should have been unscrambled by RBS and that would have been a better way to sort out some of their problems. Indeed I think the Competition Regulator should have objected to both lots of mergers and should have been listened to. Arguably they did object but they couldn't make their case and get the government to trust in the policy; it would have been better if they had done so.

So the second phase of the crisis has its grand finale towards the end of 2008 and it is as late as then that those of us who were saying to them, don't think this is just a financial crisis, that this will have knock-on effects to the rest of the economy, this is going to have a big impact on the real economy.

iii) The boomerang and 'monies go round'

So we then enter, as 2008 ends, the *third stage* or third crisis – if you like the boomerang phase. We had had the *boom* phase up to 2007, we had had the *bust* phase up to the end of 2008, and we now had the attempted *boomerang* phase to boomerang out of the disaster of the industrial slump, the cuts in consumer well-being, and the banking and financial crisis which had hit during 2008. And none of us have ever seen anything like this. It is completely uncharted territory. We not only have official interest rates near to zero but we have now this huge quantitative easing programme to try and inject cash into the system.

Am I worried that it is highly inflationary? No I don't think it is highly inflationary in the short term. I think the supporters of the policy are right, that in the short term inflation is not a big problem worldwide and, even in Britain where we have a more persistent inflation problem than elsewhere, it is not immediately going to take off. Why should that be? Well because I think what they are doing at the moment is that they are creating a money-go-round for the government rather than injecting a lot of cash into the real economy. What seems to be happening is that the government issues a whole set of bonds to try and pay for its colossal deficit. At the same time the Bank of England wades into the market and buys similar bonds in similar quantities to the ones the government is issuing to pay for its deficit and the Bank of England will buy those off pension funds, or off rich individuals, or off insurance company funds or whatever, and then the Regulator comes along to the banks and says you need to have more short-term cash. How do we define short-term cash? Well, isn't it convenient, short-term government bonds are a very good way of holding short-term cash, so then the cash redeposited in the bank

by the people who sold their gilts is then lent by the banks back to the government, so you have this wonderful circular motion going on which means that the money doesn't filter out of the banks into the productive sector. The productive sector is unable to borrow, certainly unable to borrow at anything like the nominal interests rate the authorities set. Large chunks of the private sector are unable to borrow on any sensible terms at all. The consumer side probably doesn't want to borrow because people are so scared about unemployment and about the magnitude of public debt that they want to repay debt, as we have seen in the not-most-surprising figures today showing that people are at last repaying debt quite quickly because they wish to de-leverage, and we have this virtuous cycle from the government's point of view that the money goes round and round to pay for this ever-growing government deficit.

But there are a few warning signs around and we go back to the position that we were in in the early- to mid-noughties. Apparently no RPI or CPI inflation, but asset price inflation. Suddenly share prices are alight, suddenly commodity prices have almost doubled from the very low levels they reached at the beginning of the year. There is liquidity around. People are putting it into riskier assets, a sensible thing they think to do with it, and it is the first sign that easing money creates mini-bubbles and we need to be very careful it doesn't create bigger and bigger bubbles, and then starts to destroy the very things you wish to create. If you allow commodity bubbles to get too big then it's a cost push on the industry you are trying to help, for example.

So what should we do now?

I don't have a great deal of confidence in the actions currently being taken, and I don't actually think anything is going to work until the banks work properly again. I think it all goes back to the failure of the UK authorities, in the case of Britain, to tackle the banks sensibly and well. Now we can't go back and rewrite history so we can't go back and regulate them properly in 2003–04 to stop them over-lending although some of us thought they should have done that at the time. We can't go back and stop the authorities crippling them in 2007–08 when they starved the money markets and force-fed them on nationalised money. They have done that. What we can do, instead of the government becoming an obstacle to sorting the banks out quickly, is say that the government should now become an expeditor of sorting the banks out. How do you sort the banks out? Well, the banks that are in financial trouble do have to cut costs; they do have

to slim down; they do have to sell assets. And wouldn't it be much better, ladies and gentlemen, if instead of having three or four giants in Britain, with a very uncompetitive banking sector and not terribly good service or pricing, we created three or four new banks out of the embers of the two bigger banks that are in the public sector, or mainly in the public sector, so that we have more choice, more competition, and less risk in any given bank. We don't need banks that are too big to fail and too big to bail, and smaller banks might follow strategies which were more sensible in terms of costs and remuneration. I do not believe for a moment that a government can design a remuneration policy for all the banks based in London. If they did design one that had any bite or success, it would drive business and talented people off-shore and – more likely – create a system that the bright brains get round all too easily, and so if you stop a bonus for this you allow a bonus for that, or if you stop the bonus altogether you allow higher basics. Whatever it is, they will find a way of paying it – if the market isn't competitive enough, if the super profits are still there to be made. I think at the moment the Regulators have created an atmosphere for super profits and so they should expect to reap what they sow. There to be big bonuses around again, and the bankers are hoping that they can get away with dumping all the failed business of previous excess on to the taxpayer – this government seems happy to do that – and then they can make much better profits on the business they are writing now and so they can play the game again. I don't think we should be allowing them to do that, which is why I think we need a policy for rapid withdrawal of the government from bank ownership, creating a more competitive bank market. Until we have that I don't think the UK economy is going to go very far because it doesn't at the moment have a banking sector capable of developing the sort of relationships, particularly with smaller and medium-sized companies, that those companies need to grow their business, and it doesn't have the kind of relationships with consumers that are going to create the demand those businesses will need either. The typical consumer now is very shell-shocked. The typical consumer thinks there are tax increases coming down the track because they have seen the petrol tax going up; they have heard about the 50% tax rate and so forth. They know the deficit is very large and the typical consumer is now also thinking that maybe interest rates are going to have to go up because the government's debt burden is so large, and the typical consumer is worried that he/she may lose their job, and that is not a good background in order to build a sustained recovery. So I think that before you can get a sustained good recovery in Britain you need to remodel the banks.

GREED WITHOUT FEAR – WHY THE WORLD'S BUBBLE PRODUCTION HAS INCREASED

Extracts from a talk given by John Authers, investment editor of the Financial Times *to members of the Economic Research Council on Thursday 29th October 2009**

Bubble making has accelerated

The basic proposition I am worrying about is that we have all known for a long time that bubbles happen and they have been very well described in the literature. The problem is that large investment bubbles were a phenomenon that came around once every generation or indeed once every two generations. You certainly wouldn't find two investment bubbles coming along within the working memory of an individual, you needed to wait a generation, you needed to wait for it to pass out of the institutional memory before the mania would come on again. For example, tulip mania was in 1637 and you needed to wait until 1720 before you get the South Sea Bubble, the Mississippi Bubble. The Canal Bubble didn't come along until the very end of the 18th century and the railroad bubble didn't come through until well into the 19th century and then after the great crash in 1929 a bubble which has lasted, driven by the rise of the motor car. The next true bubble doesn't come along again until 1980 – the great spike in the gold price at the end of the inflationary 1970s.

What we have had in the last few years is that we are very much better at producing bubbles than we used to be. By my count in the 1990s we had Japanese stocks, Scandinavian banking stocks, my old friend Mexican stocks, the Asian Tiger economy sports bubble that burst and of course the dot.com stocks at the end of the decade. And then in the last few years the bubbles that have burst would include, obviously US house prices, the US structures credit market, the Chinese A-share market, oil, Asian stocks, Brazilian stocks, industrial metals, foodstuffs, emerging market currencies (the Brazilian real particularly, but many others), the Australian and New Zealand dollars. You see, it has crossed the world; in remarkably synchronised fashion we seem have blown up very many different investment bubbles beyond anything that the economic fundamentals would seem to

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* The Council understands that the points raised in this talk are being developed for a forthcoming book and very much looks forward to its publication in the near future

justify, and obviously particularly alarmingly they all came down at once. There is a parlour game that I enjoy playing with my video, where at one point you could take more or less any two variables you wanted and they would look identical. Everything fell at once.

Kindleberger understood – 30 years ago

The question therefore it seems to me is why has bubble-making accelerated and what can we do about it? I have been talking to a lot of people while this has been going on, I have read as much of the literature as I can. Charles Kindleberger's book *Manias Crashes and Panics* still seems to me to have the taxonomy exactly right, and he makes the clear point that a bubble is a phenomenon of human nature rather than an economic phenomenon. You have the classic interplay between greed and fear and when greed somehow overwhelms fear you create overconfidence and that leads to a world in which investment is superseded by speculation because people work on the assumption that things will keep moving, that they will always be able to sell to somebody else who is an even greater fool.

Now there are some key things that you do need for this to happen, as described by Kindleberger. One is plausibility. If you think about some of the great bubbles in history, the internet, or canals, or railways, or cars, they are all plainly genuinely transforming technologies, they had a very great effect. Japan did indeed have quite an economic miracle, so did the South East Asian Tigers. Tulips are at least very pretty! I, and quite a lot of other Wall Streeters, went along when the New York Botanical Garden had a very large exhibition of very rare and classic Dutch tulips a few months ago. I couldn't believe I missed the interconnection thing. They are very pretty indeed and there was a lot of explanation about how difficult it is to breed a tulip and you have all that scarcity value as well. Anyway, there is some degree of plausibility before a bubble can take off.

The other critical element is you need money. You need to make finance much easier, much cheaper to come by, and then you have the fuel for the baser human instincts to be allowed to take over. Obviously there was an element of plausibility to a number of the different bubbles which we got last year and very much more obviously there was an awful lot of very easy money floating around in the system, a lot of it in many ways endogenously created.

Greed seems constant – but fear has been reduced

Now the problem is, if this is a phenomenon of human nature, then that would imply that in some ways human nature is changing if we are becoming so much more prone to creating bubbles. Obviously we hear an awful lot about greed. I spend my life in Manhattan and there are plenty of people who work on Wall Street who are indeed somewhat greedy although actually who are also very, very generous in their private philanthropy. However I really find it very difficult to buy that people are any greedier these days than they used to be. I think instead what we should look at is that essential fear that capitalism in general and markets in general need the interchange of greed and fear to function, I would argue that over the last half-century that sense of fears for various reasons has steadily been squelched down. There are some reasons that no politicians, no investors could have done anything about; there are other reasons that are harder to excuse and it is in that that lies the propensity for the bubble creation that we are now living through.

Reduced by the 'cult' of equity

Now I find the easiest way to try to work out how this happened is to go back to the world of 1954 and to explain why I did this – the thing that first attracted me to this is the year when the US Stock Market got back to where it had been in September 1929 – it took us 25 years for the US Stock Market to get back to where it had been – it actually happened the day before Thanksgiving, and a large number of Wall Streeters enjoyed themselves very much. But this was a point where we had finally come back to some point of balance between greed and fear, but also very interestingly until last year the last time when equities were still cheaper than bonds on the basis of comparing dividend yields with bond yields. For the data I have seen going back to about the 1870s, until 1954 the logic was stocks have variable returns, they can go down, they are riskier, you need to demand a higher yield, and since 1954 the argument has been stocks have variable returns, they can grow and bonds can't so you need to get a higher yield from bonds. The whole perception of the cult of the equity started in 1954 and it was at that point that those two asset classes were actually in balance, and from then on until some time in October last year when that data line from the charts finally crossed. This it seems to me was the dawning of the cult of the equity.

Reduced by apparent mathematical certainty

It is also the point at which Harry Markowicz had just started publishing his ideas that would eventually become the efficient market hypothesis – the whole field of quantitative finance, the whole notion of being able to allocate assets finding specific points on a so-called efficient frontier to balance risk and return; all that field of ideas basically came out of academia in a roughly twenty year period from 1954 to 1973. At this point we are still in a world where investment is carried out without the apparent certainty that was produced by those mathematical models, and then if you take a look at what the world looked like then, it is quite interesting – some of it before I was born. It is very interesting to see how much it had changed. Demographically the developed world was extremely young; Bretton Woods was still in force so although you don't have a hard gold standard you have currencies that are basically linked to the dollar and the dollar is linked to gold. The ability for currencies to move as fast as they can now is obviously much more limited and the world itself was a much smaller place as far as capitalism is concerned. We were divided into three worlds – the capitalist world, the communist world and the Third World

Reduced by positive surprises

Stocks gained in many ways during the whole of the latter half of the 20th century with positive surprises, given what it had been reasonable to expect back in the 1950s – the emergence of Germany, the emergence of Japan, the peaceful end to the Cold War, the emergence of China thereafter, the mere fact that we avoided a nuclear war – the kind of risks that seemed reasonable to take into account perhaps in the middle of the century, just didn't happen and the kind of outcome that we in fact had by the end of the century was that there were plainly very many reasons why we would see stocks to continue to go up very much indeed.

Reduced by the way the financial world is run

Now I think one of the critical reasons that led to the ability to form as many bubbles, is the nature of the way that the financial world was run. In any number of different spheres of financial activity we can now see a split between the principal and the agent. That is most obvious or has been most widely talked about when it comes to securitisation. The fact is that the person who looks a borrower in the eye and decides whether to

lend them a mortgage is no longer the person who takes the risk that they will default. Similarly you see the role of the banker has steadily eroded and is replaced by the capital market. Decisions that were once taken by individual bankers were taken instead by capital markets and diversified across markets.

The one thing that perhaps I hadn't quite grasped until recently is that it is not just at the level of lending decisions that you see principal/agents divisions occurring but it is also at the level of investing, the level of asset prices. Quite remarkably to me in the mid-1950s, according to the Federal Reserve, more than 90% of the stocks traded in the US were held by households, by individuals, and less than 10, perhaps 6 or 7% were held by investment institutions, with a tiny figure held by foreigners; now we are less than 40% held by those rich individuals. The marginal investor in the US stock market, and obviously the pattern is the same for other stock markets around the world, the marginal investor is now a large institution. In the 1990s it was a large mutual fund; for most of this decade it was a heavily leveraged hedge fund; it now appears that again the large investor is a mutual fund. But the point is that there was a transition from wealthy individuals investing their own money to a relatively smaller group of institutions, most of whom are following the same models and following guidelines, investing someone else's money. This very much changes the nature of how you would expect market outcomes to proceed.

Reduced – for individuals by the development of index funds

At the individual level, the first index funds didn't arrive on the scene until the mid-1970s and in many ways it was impossible to produce an index fund that replicated performance until you had really quite strong computing powers; it is a difficult mathematical operation to replicate an index. But the key point about an index fund, although it is an extremely good idea for most individuals because you cut your costs and on average you will get a better return from an index than from the vast majority of their active managers, you are exploiting the fact that the market is basically somewhat efficient and very difficult to beat. But by investing in the index fund you are making the market less efficient. An index fund has no choice but to buy whatever anybody else is buying. If it's 1999 and Cisco is trading at 400 times earnings – which it was, unlike Amazon which was … it didn't actually have any earnings – you have no choice but to keep on buying Cisco if you are running an index fund. The steady increase in

passively-managed funds therefore led to a steady increase in the proportion of the market that was just dumbly following whatever a few people were doing. It made both bubbles and meltdowns much easier to happen. You could call it a paradox in efficiency, but I am ever more inclined to the belief that passive investment management is a very dangerous idea and is in many ways a very harmful concept; it also has a role in diminishing the amount of oversight, the strength of shareholders, because obviously an index fund is going to hold the stock come what may and isn't going to start getting difficult with the Board of Directors. For an individual it is a rational thing to do, I do have more or less all my niggardly personal funds in index funds, but in the collective it does appear to create great problems.

Reduced through allowing increased indebtedness and baby boomer funds

When we get to the concept of easy money – I don't want to talk too much about the credit market simply because I think it has been so widely discussed but if people want to ask questions obviously I have had a lot of fund watching it. I do, however, think it's important to mention another thing that has bred the over-confidence, this lack of fear, this sense that things could carry on for ever is the extraordinary increase in indebtedness that the US consumer was able to get away with. In 1954 household debt as a proportion of disposable income was about 40% and by the end of 2007 it was 140% and the savings rate … very shortly before that had gone negative for the first time in history.

In the world post-Paul Volcker since the early 1980s you did have a remarkably strong and steady pattern that all yields inexorably fell. There were cycles – they would rise, they would fall, they would rise again. Each peak was inexorably lower than the one that preceded it – you could draw a perfect beautiful trend-line through it.

Now the other critical point, and this is nothing that policy-makers or financiers could do anything about, is demographics. In the mid-1950s you had the baby boom. So in the 1990s as American baby-boomers realised that they might be behind on their retirement, they got word that the thing to do was to pour into stocks, and that you had to buy on the dips, and so the crises of the late 1990s where overcome largely thanks to the great confidence of American retail investors. But plainly the demographic factor goes into reverse in the next few decades.

Reduced through policy

And finally, again this is a subject that has been talked about very much, there is the growth of moral hazard stoked by the sense that there would be a bail-out if things went wrong. The Alan Greenspan Fed certainly gave people the impression that if stock prices go down, interest rates will come down and we'll be alright. And that particularly allowed the hedge fund sector to build up its leverage.

An so many markets have become synchronised

Then you have the entire creation of the emerging market equities as an asset class and that foreign exchange became in many ways an investable asset (plus you can get an exchange traded fund that invests in the carry trade; there is the borrowing in low-yielding currencies and parking money in high-yielding currencies). And the same thing has happened with oil and other commodities. There have been developed markets for a long time but they were played in by people who actually had a stake in oil or in metals or whatever, and they haven't until recently been a playground for asset allocations for people who were also investing in other asset classes. These new players were interested in doing so because their returns had not been correlated with stocks and bonds, but after people start moving money into and out of the commodity complex on the assumption that it isn't correlated with stocks and bonds, of course it does become correlated. It is some kind of reversion of Goodhart's law. If you rely on it not to be correlated then it will start to correlate.

So we have had a very long period of about half a century when you had a number of unrepeatable circumstances that allowed financial markets to do very well for a long time and that has bred overconfidence. This has coincided with some grievous policy errors which allowed the bubble to get much bigger when it could perhaps have been allowed to burst more fully and without affecting so many different sectors of the economy at the beginning of this decade.

Policies for the future

In terms of my tentative conclusions for what we might actually do to stop this happening in future I think we need a much broader new compact which will include some idea about exchange rates, and we need to regulate big banks like water companies, or split them up somehow or other. My

preference is splitting them up somehow.

Finally I do think, given the way that the demographic picture changes, that we need to come up with a new accommodation for pension schemes, for working out how we will fund the many people who want to retire in the next decades, and finally we need to hope that the optimists win again, just as they did in the mid-1950s. If the US consumer can sort itself out without crashing the economy; if China can somehow or other keep going like this without some very big bump in the road at some point; if the entire situation in the Middle East resolves itself peacefully, etc, etc, that will be a lot of positive surprises, a lot of risks that are priced in, won't have happened, and that will allow everybody to improve. As I see it at the moment, my belief and my fear is that we've essentially got through the last few months by replacing the easy money that was created by alchemy and over-confidence in the credit market with money that was directly created by governments. I am not saying that that was necessarily the wrong thing to do but we do need to recognise that that's what's going on, given the way that different markets are again marching in locked steps, different perceptions are reinforcing themselves upwards, it does look to me, if we are not in a whole new effervescent great bubble, there is a very great risk that we are in the process of forming one.

THE CAUSES OF EXCESSIVE BANK BONUSES AND A PROPOSED SOLUTION

*By Christopher Meakin**

Since the Summer of 2007, the civilised world has watched aghast as a financial hurricane has ripped through its banking system. The resultant monetary losses and confidence losses have demolished stock markets, wrecked property markets and thrown millions of people out of work.

Why? The immediate answer is simple. Too many banks had been taking on too many reckless risks, and eventually these toxic loan books

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brought them to their knees or even flattened them altogether. That in turn generated a crisis of credit confidence and a hiatus in bank lending which swept though much of the civilised world's economy.

And why was that? Again the answer is simple. A mushrooming culture of over-rewarding top management generated huge cash bonuses for them, running in some cases into tens of millions. Even worse, it was a classic one-way pendulum. When the reckless lending by banks paid off, and the banks made big profits, top management benefited hugely. Yet when reckless lending didn't pay off or even worse came unstuck, it was not top management but shareholders and customers of the banks who footed the bill. Yet another case of heads we win; tails you lose.

It was a formula for disaster. Exploiting their privileged power in the boardroom, it was in the very best financial interests of such top management to push their banks into every kind of reckless lending. An 'enterprising free market culture' had established a one-way pendulum in banks around the world, most so in the USA and the UK. In the contemptuous eyes of the French, it was very much an 'Anglo Saxon Problem'.

In the USA the rush into toxicity was exacerbated by encouragement from the White House itself. The political aim, for largely electoral reasons, was to extend the joys of home ownership into an underclass who really could not afford mortgage payments. This politically-driven momentum led first to the problem of, then to the full-blown crisis in, sub-prime lending. Federal mortgage authorities like Fannie Mae and Freddie Mac were hastily bailed out by the US taxpayer, not of course by the politicians who had triggered the sub-prime crisis in the first place.

Meanwhile in the UK fast growing, over-ambitious mortgage companies like Northern Rock devised a homespun version of America's sub-prime crisis. Their management would pick up bonuses from any success, but it was their shareholders who would pick up any cost of failure. Another one-way pendulum. Eventually their providers of wholesale funds took fright at the loan book, whereupon the supply of wholesale cash into their balance sheets promptly dried up. This time it was the turn of taxpayers on this side of the Atlantic to pick up the bill.

All good things must come to an end eventually. A fifteen year boom market in housing from the early 1990s was just one of them. It takes a rare economic naïvety in Whitehall or 11 Downing Street not to be able to spot that inevitability from a safe distance. However that is the normality of Labour governments, and the periodic lapse of Conservative governments, in this country.

It is now many years since the former were told collectively that they couldn't even run a whelk stall properly; more recently it has been suggested they could not even park a bicycle with the requisite degree of insight. Such are the talents of folk who worm their way onto the ballot paper at general elections. As we have seen most recently with the Commons expenses' scandal, hey are the sort of people for whom a pseudo-bonus culture is to be prized above rubies, or at least above financial fair play. Unfortunately they are the same people who hold our financial fate in their hands. In centuries past it would have been the very stuff of which revolutions were made.

American Bankers' Bonuses

Here are some interesting figures for 2006, the last full year before the financial and economic crisis:

Lloyd Blankfein, CEO Goldman Sachs: $54.7 million
'Chuck' Prince, ex-CEO Citigroup: $26 million
Stanley O'Neal, ex CEO Merrill Lynch: $48 million
John Mack, CEO Morgan Stanley: $41.4 million
Richard Fuld Jr, ex-CEO Lehman Brothers: $40.5 million

The figures shown are made up of basic salary, share and stock options and, crucially, cash bonuses. Why so much? Because of that one-way pendulum. When the bank made massive profits, the CEO received a very healthy rake-off. But when the bank made losses, massive or otherwise, the tab was picked up, not by the chief executive and his cronies, but by the bank and its shareholders.

It was a formula for disaster, as we all now know. One does rather wonder what on earth the non-executive directors of the banks thought they were playing at. Or were they simply bribed into silence as well? In the good old days, only the chief executive was allowed on the board of a bank. All other board members had to be non-executives. It was a fundamental principle of good bank governance. No longer. The good old days are gone.

A possible solution to the problem of excessive bonuses

Politically Correct doctrine decrees that no politician should be allowed to interfere with the workings of the free market. Least of all should we

introduce a special, higher, tax rate applicable to bank bonuses alone. That's quite unnecessary anyway. So let's go along with Political Correctness. We need to devise some kind of bonus pot into which bonuses can be paid in good years, but from which funds are then extracted in the bad years. And it has to be a self-working mechanism which the bank has entirely determined for itself, in advance. Free market stuff, you understand.

Here's one way it could work. A bank will first be told to nominate its anticipated normal level of profits, on a rolling annual basis. The matter of precisely defining the accountancy standards for determining profits immediately looms into view, but it is an area beyond the scope of this article. It is also an area which many people would like to seen cleaned up, and not just in the banking sector.

If the bank achieves precisely the predicted level of profits, thus clarified, it would then pay a pre-determined proportion of those profits into the bonus pot, perhaps for the board, perhaps for all senior employees. That percentage rate would of necessity have been ratified beforehand by bank's shareholders in a wholly transparent general meeting.

Any profits achieved above that self-devised level will also pay a percentage into the bonus pot, but at a reduced rate. The AGM would determine and ratify that rate as well. Faced with this dilemma, the boardroom estimate of future profits would be pitched as high as possible.

However, any shortfall below that self-devised level would have money extracted from the bonus pot, also at the lower percentage rate. We need not be too cruel. Compliance with this simple rule book would be monitored by the bank's outside auditors in the normal way. The difference is, the rate at which bonuses were calculated would now be completely visible in advance, no longer an arcane secret within the bank.

This change in practice has a good precedent. After the second world war, British banks were no longer permitted to keep inner, secret, reserves which they could use to manipulate the level of declared profit out of the public eye. In Hong Kong such 'inner reserves' were permitted until the 1990s, and one of the various reasons the Hongkong and Shanghai Banking Corporation became such a success story.

Using the proposed structure, a bank and its shareholders would be free to pitch the predicted level of profit and the percentage paid into the bonus pots anywhere it likes. There would be no interference whatever in free market liberalism. It is just a matter of a slightly more sophisticated Rule Book, but one which applies equally to everyone, each and every year.

In other words, the bank's executives would now be over a barrel, which

is precisely where they should have been all along. Pitch the 'normal' level of profit too high, and they are hung by their own petard. If the profit out-turn is less than that, as it is would most likely be, large sums would then be extracted from the bonus pot. Pitch the 'normal' level of profit too low, and the bank would now be vulnerable to take-over bids. So what was once a one-way option in deciding bonuses now becomes a two-way option and not only that, it becomes a very fine calculation.

It all sounds deceptively simple, which is the objective. Yet in practice it imposes a ruthless regime which penalises the chairman and his cronies whenever the bank has a profits shortfall, just as much as they are rewarded when profits are high. Suddenly that catastrophic one-way pendulum has disappeared. They will have to learn to be genuine bankers again, not just rip-off merchants driving the bank into high risk, high reward territory solely for their own personal gain. Because if they did shove the bank into incautious investments or lending, they would now pay a personal penalty for any resultant profits failure. Meanwhile any over-caution on profits forecast would – as always – invite a takeover bid and that would put not their bonuses, but their entire job at risk. They certainly wouldn't want that, now would they?

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The second part of this article, tackling the further problem ‘If a bank is too big to fail, it is too big’. will appear in our Spring issue.

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A RETURN TO CERTAINTY

By Damon de Laszlo

As we head into the new year it does not seem that much advance has been made in returning the global economy to ‘normality’ – whatever that is.

The US economy is stabilising. That is the deteriorating trends have now flattened out but the piling up of debt at National Government and State level still continues. China with its huge resources is pouring money into infrastructure and primary industry – steel, aluminium and concrete

etc. Russia seems as determined as ever to destroy its economy by creating uncertainly in the Courts; one of the first needs of economic growth is certainty of the enforceability of contract. Europe is a special case; the great concept of a free market for goods and services seems of late to have been entirely lost in battle between the political elite of the various member states as they manoeuvre to get position at the top of the EU hierarchy. Europe also seems to have totally forgotten the concept that leaders are best selected by democratic process.

Continuing thoughts on Europe, it seems clearer and clearer that the union is becoming economically, as well as politically, dysfunctional. The so-called PIGS – Portugal, Italy, Greece and Spain – are heading towards economic disaster as their Governments fail to address their burgeoning deficits.

As always, France paddles its own canoe, really very successfully, while Germany takes the strain. The German economy, however, is facing enormous strains. It relies on exports to a greater extent than any other advanced economy and the decline here has been dramatic. German companies have not downsized but have been relying on their economic fat to sustain them. German banks have still not addressed the high level of unrecoverable debt and derivative instruments that they hold on their balance sheets. Add to this the high level of the Euro against the Dollar means in all probability that Europe will be the last region to recover from the present crisis.

The economic debate about the probability of a Dollar devaluation seems to centre around whether it will be fast, ie a crisis, or slow, the least painful way of dealing with the Government debt build up. What is forgotten is the Chinese have the ability to keep their currency pegged to the Dollar and their seeming determination to do so. This means that the Euro and the Yen, along with a few currencies primarily linked to commodities will be on the other side of the equation. Unlike Europe, Japan's Government and economy is switching focus to China, and will continue to be one of the primary beneficiaries of Chinese industrialisation.

Strangely, the beneficiary of the current economic realignments seems likely to me to be America. The American population have moved from a five year borrowing and spending spree into savings mode. This will reduce imports. US industry is rapidly restructuring and will over the next few years gain market share in both domestic and in the export markets. I think US financial markets will also benefit as it becomes clearer that the only place to invest surplus cash is in the US. Dubai has thrown sand in the wheels of the fascination with alternative markets for the time being.

In finishing, it is worth a quick thought on the UK. As I have said before, the UK Government has effectively ceased to function in the run up to the next election. The lack of coherent policy offered by the political parties is likely to lead to a hung Parliament or at best one party with a minute lead.

The current Government having lived off the service sector, and the City in particular, has through taxation and legislation slowly strangled UK industry and so far produced no policies for the future.

The Conservatives have succumbed to lobbying from the City and embedded Greens within their party, seems to have decided that industry is bad, finance and shop-keeping is good, and the lights will be kept on by windmills! Their tax policy of reducing Corporation Tax by a few percent and removing the ability of companies to write-off Capital Expenditure means that the prospect for industrial growth and re-building of our energy and transport infrastructure will go out of the window. The new year brings the prospect of higher prices in the shops and rising unemployment caused by a large increase in insolvencies as companies find it more and more difficult to meet their pay roll and taxes and the Revenue get more desperate to collect everything they can.

While the above may seem depressing, I feel optimistic. There are likely to be less surprises as the world hunkers down to dealing with the economic surprises that have been the hallmark of the last eighteen months. While things may be dreary and difficult, some semblance of certainty will return.

TEN YEARS ON BRITAIN WITHOUT THE EUROPEAN UNION

Lee Rotherham, published by TPA 2009 p/b £5.99

When Britain changes its relationship to the rest of the European Union into some sort of Swiss or Norway-like status an event which alarmists will inevitably call ‘leaving the EU’, there will be interesting consequences. These consequences, felt by groups as diverse as large businesses, workers, farmers and fishermen, consumers, police, and traders will play out most noticeably during the initial decade and will, almost inevitably result in some other countries from the current EU membership, seeking major changes for themselves.

Everyone knows that these consequences will involve us becoming better off economically and having greater flexibility in our relations with the rest of the world. The problem is to find a way to break this down into a meaningful narrative for each of us in our various walks of life. Such a problem can be solved – who would ever have thought that the most boring institution in the world, the Civil Service, could become the basis for the most successful British comedy series 'Yes, Minister'?

One way is to publish lengthy learned treatises. For example Douglas Jay writing in 1966, Enoch Powell who wrote 'Still to Decide', Peter shore who wrote 'Separate Ways' and the Institute of Economics booklet 'Better Off Out'. The trouble is that nobody can read such things joyfully and so few bother to read them at all. Such treatises are most certainly not a 'Yes, Minister' solution.

Rotherham has removed the depression aspect by simply writing a short book *as if* writing in the year 2020, and he describes, as any good historian might, the developments of the 'past' 10 years – the decade since Britain's historic change in its relationship to the EU which 'took place' (and he describes just how that took place) in 2010. Happily Trevor Kavanagh (of *The Sun*) and Frederick Forsyth (author of *The Day of The Jackall*) are still around in 2020 to write the Forward and the Epilogue. The result is an excellent little paperback, informative, sensible and a pleasure to read.

J.B.

CATCHING UP WITH DEVELOPMENTS IN EAST ASIA CHINA INDIA JAPAN AND KOREA

Capitalism with Chinese Characteristics, Yasheng Huang,
published by Cambridge University Press 2008 H/B £15.99
and
Shutting out the Sun, Michael Zielenziger,
published by Vintage Books 2007 P/B £9.07

So you think that China has forged increasingly ahead during the last 30 years with prospects that are bright indeed; you think that India has been left far behind; you think that Japan has 'got what it takes' to rise again

from it's current difficulties, even if it must cede the title of the 'world's second largest economy' to China; and you think of (South) Korea as an economy following in Japan's footsteps, currently perhaps just 10 years behind.

All these views were widely held – and were credible – only a decade ago but take a look at *Capitalism with Chinese Characteristics* (which in part. compares Chinese with Indian economic developments) and *Shutting out the Sun* (which in part compares Japanese with Korean economic developments) and you find that you are wrong on all counts. Given our reluctance to abandon preconceptions, it takes courage to tackle these two remarkable books.

Huang points out that there are 'two parts' of China – rural and urban and China in this sense is similar to India but very different to Japan and Korea where most of the population lives in or near large cities. One tends to think of Chinese urban areas as the motor of growth the modern entrepreneurial, wealth creating centres slowed by a vast and hopeless conservative rural population. Huang convincingly argues that this is the reverse of the truth; rural entrepreneurship is the key dynamo of Chinese capitalism whilst the cities are, if one may exaggerate the point, 'parasitic'. We are invited to examine the three policy periods – the 1980s, the 1990s and recent times under the leadership of Hu Jintao and Wen Jiabao.

The 1980s was a time of liberalisation, a great release of entrepreneurial energy through a vast number of small and medium sized ventures, especially in the rural areas. Low taxes, available loans, accommodating (and not too highly rewarded) local officials and a central government attitude of 'go and make money', together with all the catching up opportunities that a more open stance towards the rest of the world presented spelt 'economic miracle'.

But, Huang argues, contrary to popular impression, this progress was not refined and accellerated during the 1990s. Instead, taxes on the rural areas were increased, local banks were restricted (and funds loaned for mega projects in urban areas), officials at all levels saw huge rises in salaries – and a doubling in numbers – whilst the central government followed an increasingly statist approach of 'picking winners' and 'guiding investments', whilst corruption has increased. Educational provision in the rural areas declined (the 1990s saw a huge rise in the number of rural illiterates), health improvements slowed and inequalities in income distribution widened alarmingly not because of differences in abilities but more because of the ability of those, especially in urban areas, to use institutions and restrictions

to grab more for themselves. Both the foreign observed face of China (glitzy Shanghai, Beijing and Guanzhou) and many misleading official statistics easily obscure the more fundamental picture – of increasing land grabs, of declining absolute rural area incomes, of an incredible rise in the number of rural uprisings and demonstrations.

The third period – our current decade – has seen an attempt to return to earlier policies. The leadership has good intent. But it is hard to overcome the old traditional view that the elites can mine the countryside for their own benefit and there has been more 'slowing the rot' than 'a return to the l980s'. China is spending its investment resources (a higher proportion of GNP than almost anywhere else on Earth) on hard infrastructure – roads, buildings, railways and rockets, rather than on soft infrastructure – the extent of education, quality of health, security of basic ownership and effective legal provision. Small wonder that Hong Kong needs to be kept semi-independent for its valuable legacy legal structure and its useful separate currency. Small wonder also that in this repressed, fragile,vast and exploding economy, individuals, institutions and even the central government desperately seeks to transfer savings out to more dependable jurisdictions – an outflow obviously matched by the requisite trade surpluses.

Add these policy issues to the more fundamental problems of a rapidly aging population, an over-reliance on foreign markets and Foreign Direct Investment and one senses that for all the superb plans and organisational effectiveness of China's bureaucrats, the future may not necessarily be of world domination!

Looking at 'The Indian Model' Hung comments 'Although many believe that China has left India behind economically, a closer look at the comparative economic performance reveals a more subtle picture soft infrastructures such as rule of law, financial institutions and directional liberalism matter more for growth than massive investments in hard infrastructures'. The gap in GNP per capita growth rates between China and India is narrowing, India achieves higher manufacturing value-added per worker than China. India's stock market is substantially more supportive of indigenous private-sector development and India's economy depends much less on government spending on mega-projects than does China's. As the marketing director of JCB (Britain's leading manufacturer of earth moving equipment) put it to me 'We have a 70% market share (of mid-sized machines) in India and our sales are growing there faster than in any other country. India today, is the place to be'.

Whereas *Capitalism with Chinese Characteristics* methodically reviews research

and statistics to reveal the true picture of Chinese (and, for comparison Indian) economic development, *Shutting Out the Sun* is a sociologist/journalist's evaluation of current cultural trends as they affect Japanese (and for comparison Korean) economic development. Since arrogance and mismanagement is the weakness of China whilst policy making paralysis and social crisis is the weakness of Japan, these two different approaches are entirely appropriate.

Zielenziger describes Japan's social malaise – the children who refuse to attend school (the Hikikomori), the reluctance of Japanese women today to marry and bear children, the drunkenness and suicide statistics. It is a painful picture of a joyless society, exaggerated perhaps, but nonetheless a necessary contrast to the 'Japan through rose tinted glasses' version of so many previous publications. Just how otherwise normal babies who happen to be born in Japan are raised and educated in ways which generate this picture is the subject for another essay or review but the point to make here is that the political management consequences are stifling and dysfunctional.

The historical background is familiar. Zielenziger as journalist puts it this way 'In Tokugawa Japan (1600–1868), Christian practice was rigorously suppressed … (after that) Japan mounted a bullet train, and travelled at breakneck speed from feudalism to industrialization, to war and then reconstruction, without ever experiencing the Enlightenment. In other words, neither the power of the individual separate from the state, nor a self separate from society, nor the validity of an individual conscience separate from group sensibilities, ever gained a toehold … Kant and Hegel never arrived on Japan's shores'. (p. 126)

Japan's 1980s asset bubble burst after 1990. Property values had risen to levels which make a mockery of anyone who describes recent UK house prices as overblown. Britain's FTSE index, currently around 5,000, would need to top 20,000 to equal anything like the Nikkei index in 1989. Japanese policy makers at least got the easy bits right – undertaking massive government deficit spending which, as Richard Koo has shown[1] has succeeded in avoiding deflationary disaster – a not insignificant achievement. But deeper reforms -privatisation, the promotion of competitive markets, the recognition of shareholder interests, the dismantling of the restrictions described by Ivan Hall[2], the ending of pork barrel government contracts, the normalisation of Japan's labour markets to facilitate skill transferability, immigrant workers – even the allowance of Japanese government

1. Richard C. Koo The Holy Grail of Macro Economics Wiley 2008
2. Ivan P. Hall Cartels of the Mind Norton 1998

employment of workers who have only one Japanese parent – seem to get caught up in a web of vested interests, bureaucratic control and weak political leadership.

The result is that whilst Japan's top companies thrive and grow like medieval monasteries, the country remains mired in very low or negative growth rates, rising unemployment, negligeable returns on new capital investments and a sense of panicky alarm every time the value of the Yen rises against the Dollar. Postponement and evasion have been the political strategies of choice. Meanwhile new buildings and modernity all around show the visitor a Japan that is the most modern creation on Earth. It is indeed wonderful, but if the Japanese people are ever going to own the rewards of this success … well, we are back to reform. Reform nearly 20 years after the need became obvious.

Zielenziger's chapter 12 'Rising Sun and Hermit Kingdom' is the 20 page excerpt every UK investor in the Asian economies needs to read. Following the financial crisis in 1998 'within three months, the new, democratically elected government (of Kim Dae-jung) launched a major overhaul of South Korea's economic system, taking the first steps to dismantle the closed, mercantilist "developmental model" which, like Japan's, had earlier propelled its sprint to prosperity. (The Administration) moved quickly to reverse thirty years of dogma. It encouraged foreigners to buy into the local economy, and urged consumers to spend. Kim acted swiftly to reduce the grasp of the nation's largest family-run conglomerates, known as chaebol and forced highly indebted firms to declare bankruptcy and shut down. Kim's government also moved aggressively to sell off and recycle assets held by failed banks as it imposed new labor laws to give companies more leeway to fire redundant workers. These startling changes of policy yielded impressive results, quickly …'. (p. 220)

Now Korea's income per head is not dissimilar to Japan's and there is both confidence and optimism. So why was Korea able to adapt and change whilst Japan seems frozen? Well, a book review should be an invitation to read rather than a summary of the information. Suffice to say – as a hint – that Zielenziger, as a Jew, admits finding himself surprised at needing to relate Korea's cheerful individualism and acceptance of change to the fact that over 60% of Koreans are Christian and have, through that route, come to adopt many Western values. Sociology (assuming that includes such things as religion) may indeed be the right interpretative tool.

J.B.

Today we mourn the passing of a beloved old friend, Common Sense, who has been with us for many years. No one knows for sure how old he was, since his birth records were long ago lost in bureaucratic red tape.

He will be remembered as having cultivated such valuable lessons in life as:
- Knowing when to come in out of the rain;
- Why the early bird gets the worm;
- Life isn't always fair;
- and, Maybe it was My Fault.

Common Sense lived by simple, sound financial policies (don't spend more than you can earn) and reliable strategies (adults, not children, are in charge).

His health began to deteriorate rapidly when well-intentioned but overbearing regulations were set in place: Reports of a 6-year-old boy charged with sexual harassment for kissing a classmate; teens suspended from school for using mouthwash after lunch; and a teacher fired for reprimanding an unruly student, only worsened his condition.

Common Sense lost ground when parents attacked teachers for doing the job that they themselves had failed to do in disciplining their unruly children.

It declined even further when schools were required to get parental consent to administer Sunscreen or an Aspirin to a student; but could not inform parents when a student became pregnant and wanted to have an abortion.

Common Sense took a beating when you couldn't defend yourself from a burglar in your own home and the burglar could sue you for assault..

Common Sense lost the will to live as the churches became businesses; and criminals received better treatment, and had more "rights" than their victims.

Common Sense finally gave up the will to live, after a woman failed to realize that a steaming cup of coffee was hot. She spilled a little in her lap, and was promptly awarded a huge settlement by the "Judicial System."

Common Sense was preceded in death
- by his parents, Truth and Trust;
- by his wife, Discretion;
- by his daughter, Responsibility and
- by his son, Reason.

He is survived by his 4 step brothers:
- I Know My Rights
- I Want It Now
- Someone Else Is To Blame
- I Am A Victim

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.

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Individual members .... £35 per year

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

Student members .... £15 per year

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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.

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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.