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AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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THE ECONOMIC OUTLOOK FOR 2011

Extracts from a talk given by Andrew Smith, Chief Economist at KPMG, to members of the Economic Research Council on Thursday 17th February 2011

Our 'Minsky' moment followed by partial recovery with some new realities

Two years ago the world came to the verge of financial and economic collapse when, not very long before that, most people thought there was nothing particularly wrong and that it was blue skies for ever. And that is exactly what the problem was. The American economist Hyman Minsky, who died in 1996, famously argued that the world does occasionally hit such a huge financial crisis apparently from nowhere if there is a long period of economic stability during which people forget about risk. With low inflation, low interest rates and reasonable growth from the early 1990s people did start doing fairly silly things with borrowers unable to pay either the interest or the capital repayments on their loans and thus becoming reliant on ever increasing capital values – in the housing market, private equity deals and even in the actions of the banks themselves with the expansion of derivative products which turned out to be worthless.

After the Lehman Brothers' collapse there was panic and lenders stopped wanting to lend to anybody irrespective of whether they were creditworthy or not. The government – just in time – stepped in to support the financial system. Now we are left with the unwinding of debts to over-extended borrowers and the need for lenders to recoup the losses incurred.

Meanwhile equity markets fell 50% but have recovered to within 15% of their previous level and bond markets have mostly recovered as well.

But economic growth in the advanced economies is not back to where it was before and there remains spare capacity – in contrast to the emerging markets, the 'BRICS', which were less affected by the crisis and have kept going up – a big twist in the move of economic power away from the West to the East.

Europe has a problem

Greece has a huge debt/GDP ratio coupled with a big annual deficit, Ireland's government has guaranteed bank's liabilities for several times its GDP, Portugal has a problem of low growth and we don't know if Spain will be able, in the face of high unemployment, to introduce the austerity measures necessary to get its deficit down. Since German banks hold large swathes of debt in these countries the German government basically faces a choice between bailing out these countries and bailing out her banks.

In addition, these troubled economies also lack competitiveness since the introduction of the euro. This has been inflating costs in their economies whilst holding the line on costs in Germany. So Germany has been improving its relative competitiveness. (Britain is still looking pretty competitive, thanks to the depreciation of the pound.)

The way the euro was set up there is no mechanism to do anything about these problems. The three choices are 'you'll have to bear that, you'll have to sort it, or you'll have to exit from the euro'. The basic problem is that these economies have never really been merged. So you are looking at internal devaluations, which is not very nice because you are saying to people that their relative wages need to fall 20 to 30% and we are going to raise taxes and cut government spending as well. And this is blurring the difference between what is sovereign and what is bank risk. The only default risk-free rate left in Europe is the German government debt rate.

In case anybody thinks that countries don't default, two American economists, Reinhart and Rogoff have shown that a lot of the time 10-20% of economies around the world have been in default. The French defaulted after the Napoleonic war, all of Latin America was in default at one point in the 19th century. Then there was the American debt crisis in the 1980s and the Asian debt crisis in the late 1990s – not that long ago.

China is upsetting the world

Over the last two decades certain exporting countries, particularly China, have been running large trade surpluses whilst America has been running large deficits. Effectively, each year China has said 'thank you very much America and now we will lend you some more money again so that you can keep doing the same thing for another year'. But now it is kind of 'game over' because America cannot afford to borrow so much so China needs to consume more at home and America needs to export more. It would help if China allowed its currency to rise but there are not many signs of that happening. Apart from a tiny little rise against the dollar which does not appear to have started a trend, the Chinese, by locking their currency to the falling dollar have actually caused a major fall against many other currencies, Brazil for instance has seen a 35% appreciation of its currency against the Remninbi. Some of these economies have even put on attempts at capital control and so forth to try and keep their currencies down.

Britain faces a squeeze on real incomes

We had a very deep recession by our standards – the peak to trough fall in GDP was something like 6%. We've hacked something like 2% of that back but there is still quite a lot of spare capacity. Manufacturing has been expanding quite strongly but we seem to have swapped a lot of full time jobs for part time jobs. The relatively small number of insolvencies is quite surprising. I think that has got a lot to do with the fact that many UK PLCs actually went into this recession in quite a good financial position and in many cases took action quite quickly. Public sector cuts are yet to come in earnest but nevertheless, things haven't been as bad as you'd have thought.

But inflation – the CPI – is now running at 4% whilst earnings growth is low or perhaps falling. So far the labour market does not seem strong enough to support large wage demands and business has been able to keep the lid on. So there is a squeeze on real incomes – real disposable income growth has been a lot lower over the past five or six years or so than it was for quite a long time before that. We have borrowed a lot to give ourselves more spending power but I don't think that we will be able to do this again for a long time. There will be relatively sluggish consumer spending growth so we must hope that exports and investments will pick up the slack.

And needs to export more advanced goods to emerging markets

I am always accused of being very pessimistic about life, so I want to make the point that, so far, things have actually turned out reasonably well. Last year global growth was 4.5% and there have been some pretty positive numbers coming out for the first few months of this year. Corporate profits are pretty strong in some economies and, particularly in America, investment has been recovering.

But, having said that, we do have this two-speed global economy where a lot of growth is coming from emerging markets. Western economies are looking at a period of pretty subdued growth and we've still got the potential for something to go horribly wrong in terms of sovereign or financial system debt. Much of the growth in trade is between emerging market countries but interestingly Germany has been doing rather well in selling to these markets. What Germany has concentrated on, as well as keeping costs down, is speciality chemicals, plant and machinery for sophisticated production and so forth. I think that if we are going to join in where the action is, try to help our export growth to compensate for the slowness of everything else in the economy, we really need to be looking to move more into those markets as well.

DAVID CAMERON'S CALL FOR NEW ENTREPRENEURS

By Jim Bourlet

Just as, in terms of colour, 'too black' can be said to be 'not white enough', 'too many unemployed' can be described as 'too few employers'. With over two and a half million on the unemployment register, many more dropping out of the labour market altogether and perhaps a third of all 16 to 25 year olds out of work, Britain's shortage of employers concerns us all. As David Cameron was moved to say '*If you are thinking of starting a business, now is the time to do it*'.

Governments have, of course always been aware of the need to encourage *existing* employers to expand and employ more. There are government training programs, leaflets from ministries, help for exporters, subsidies for businesses in some regions and exhortations to the banks. Over decades we have heard endlessly about the need to reduce business taxes, cut red tape and challenge (notably EU) regulations.

Following Keynes we have, more or less, accepted the claim that boosting overall demand through fiscal deficits and money supply growth, is a necessary condition for full employment. Necessary, but not *sufficient*. Demand management is only to hold the horse's reins or to be the driver of the car. One also needs a good horse, a decent engine or a dynamic business scene to win the race, move the car, or achieve full employment. Keynes, accurately in his day, observed that the 'animal spirits' of new entrepreneurs provided a reliable and apparently endless supply of new business start-ups. Entrepreneurs just popped up everywhere like vigorous seeds in a garden. The economist didn't need to concern himself with entrepreneurship; it could simply be taken for granted. And it could be exploited for the benefit of all – it was simply the bounty of nature. To achieve full employment new business start-ups provided fecundity, flexibility and imagination; the competition to keep existing businesses on their toes; and a chance for the unexpected to flourish. It was the new generation in action.

New entrepreneurship does, of course still exist. There are high tech start-ups around Cambridge University, there are amazing dot-com companies and there are importers of low cost Chinese gadgets. There are immigrants (notably Jewish and Asian) who, without qualifications, start clothing or publishing or property development businesses, and some make fortunes.

But amongst those who grow up here (including the children of entrepreneurial immigrants) a far smaller *proportion* aim to start their own business now than did just two or three generations ago. What seemed eternal to Keynes in the 1920s presents a very different picture today. We can think simply of our own personal experiences. In the 1920s one of my grandparents started a wholesale confectionery business and another owned a village bakery. An uncle ran a house building business (employing 20 men) and another invented a tractor drawn potato digger and built an agricultural machinery business. But amongst the current generation we have, not entrepreneurs, but a lawyer, a doctor, a policeman, a university teacher and an executive in a mid-cap company. Yes, there is just one who has started a business – but not in this country. This is the reason why, instead of talking about 'too many unemployed' we should ask why there are now 'too few employers'? Why are there too few new entrepreneurs? Why, in 2011, does a Prime Minister have to plead for more business start-ups when his predecessors – Gladstone, Disraeli, Peel or Lloyd George had no such concerns?

Starting a business for the first time is something most often possible for the young. Historically, a youngster, having made such a decision, commonly worked with a 'master' for a few years before setting up on his own. Capitalism's demand for flexibility always falls disproportionately on the young – older workers prefer their existing occupations but their children can set a different course. Those between 17 and 25 are in the best position to risk all on a gamble. They are not yet burdened with mortgages, families or high expenditure expectations. Caution has not yet descended on them and living cheaply with parents is no great shame. A failure or two at this stage of their lives won't matter in the long term. In fact, the experience of trying, even if abandoned, might still be 'character forming', is still personal development and may still be a valued item on a CV. The 'learning curve' for the new entrepreneur is steep and many sided and, although no paper certificate will be issued, is a qualification of inestimable value. And, just as a person who was once married is more likely to marry again than someone who has always been single, someone who has once been an entrepreneur is more likely, after working elsewhere, to start another business than is someone who has only ever worked for others.

And starting in business is more about personal ambition than about possessing a great 'idea'. A young person who is willing and enthusiastic to help friends and neighbours finds that doing something as a business is a paying proposition. Helping outdoors might lead to a landscape gardening business, repairing household electrical units might lead to a kitchen installation business, helping Mum might lead to starting a restaurant, helping Dad lay the foundations for his flat-pack greenhouse might lead to a building business, doing cleaning jobs might lead to a 'facilities management' company. The list is endless and once a start is made, the young entrepreneur can look around at those who are successful in the area and set out, not initially to do better, but to imitate and copy what others are doing well. Some time later, from the swirl of ideas around, one or two may catch his attention and be taken up; honed into something that may be profitable – and perhaps paraded in the 'Dragon's Den' TV studio.

So typically, the starting scale must be small. People start 'little' businesses. Few are willing to borrow large sums and share those precious early earnings with a bank manager. The qualities required to start a business are such things as self-confidence, unrealistic optimism, a wish to be independent, persistence, a willingness to seek and take advantage of advice, a good 'short term' memory, some ability to get on with people, personal drive, common sense and reasonable competence, a basic education with computer familiarity, and some supportive relatives and friends. It helps enormously also to have others around who have small businesses who act, in effect, as role models. This list does NOT include a university degree or possession of a large sum of capital.

Viable opportunities for doing something useful that can be profitable are all around us – loads of them. But many are destroyed, others are blocked and yet others overlooked. This point may be difficult to prove, but can easily be illustrated by examples.

Look at the road from Winchester to Basingstoke. On the old A33 there used to be several transport cafes, four garages and some other shops, all making business from passing traffic. Now there is the M3 and a motorway service area complete with an over-priced chain store, a monopoly petrol station and four fast food units including Burger King and Costa Coffee whilst on the old A33 the little businesses are now gone. Whereas before, small independent businesses could be set up at minimal cost, now there is only opportunity for high rent paying established chains. It need not have been this way. In other countries one can find motorway junctions signed 'turn off for services' and, for perhaps half a mile or so on either side there are lots of independent (and chain) shops, restaurants and other businesses. Planning restrictions and the greed of the transport ministry here have conspired to block opportunity.

Less excusably, consider what happened when Southwark Council inspired the 1960s Elephant and Castle shopping centre – itself a pale insult to the rather attractive 'Kensington of south London' area that it replaced. Southwark then sought to close the various small shop clusters in the area ('chose not to support' was the expression used) in order to make the new shopping centre – with its Tesco, W.H. Smith and Boots – profitable.

Look at the provision of nursery education. Parents are willing to pay for private kindergartens (and in other countries the local authorities sometimes reimburse parents much or all of the fees in the interests of 'equal access'). Such small businesses began to flourish here in the 1990s but the government – for crazed ideological reasons – has been determined to undermine their development by offering places in government primary schools for four year olds, threatening not to accept 'late entrants' and providing 'Sure Start' schools to drain demand from the 'private sector'. It need not have been this way. In Japan, there are thousands of splendid little private kindergartens (Yochien), licensed and regulated to be sure, but competitive. They are actually the best part of the much vaunted Japanese education system.

Look at the demise of the many traditional small builders in this country. They have almost all been squeezed out of existence during the past half century as resources and permits have flowed to a few big firms and to public housing contractors. Small scale, which is actually what home buyers need, is now hard to find except in terms of 'cow-boy' unreliability.

Look at big super-markets granted planning permission for large stores with a vast car park 'out-of-town'. One can be in favour of large super-markets but not their monopoly use of the car park permit. With a captive car parking customer base they can diversify into selling clothes, books, insurance and goodness knows what. It need not be this way if only the planning consent for the car park had been subject to the supermarket having to provide spaces for small independent businesses on the 'vacant' three sides.

Look at that most modest of accommodation provision – simply renting out a room in one's own home. Thirty years ago Margaret Thatcher established the 'rent-a-room' scheme whereby up to about £2000 a year in income from such activity need not be declared for income tax purposes. £2000 was a realistic rental sum then. But the scheme has withered as the Treasury failed to increase this in line with inflation.

The story of squeezing out small entrepreneurial opportunities is an old one. For example, during the war years, supplies were allocated to the bigger retailers such as Marks and Spencer. Shamefully, small retailers were forced to redirect their loyal customers to the larger stores where supplies were available. So, many went out of business. But all around, the effect is the limitation of entrepreneurial opportunity as an unintended consequence of government action.

This is important because, in time, some small entrepreneurs become major employers. The Virgin empire started with a small shop, as did Laura Ashley, the Body Shop, and Tesco. MG cars started with a single garage and Honda Motors started when Soichiro Honda returned from the war and decided to use a war surplus small engine to motorise an ordinary pedal bicycle for his wife to go shopping on.

Perhaps the first step in correcting this situation is to require all government proposals at both local and central levels to contain a 'small business impact report' in much the same way as there is often an 'environmental impact report', already. Such a report should not focus on protecting small or any other existing business but rather at making decision-makers at least aware of how their proposed action will limit or promote entrepreneurship *opportunities*.

Secondly, there needs to be a recognition that new businesses need a relatively forgiving official attitude in order to grow. All too often high intentions have loaded employers with responsibilities through employee rights, health and safety regulations, tax administration, consumer rights and 'social' obligations. Struggling under these burdens small business people all too often advise the young against starting a business. Putting one's head in a noose is not a good idea. We must recognise that business start-ups need nursery circumstances until they have the strength to meet society's demands. Somehow we must exercise tolerance, leniency and flexible interpretation of the law to show that entrepreneurship is valued.

Some part of the explanation for the vanishing proportion of entrepreneurs amongst the young must lie with our current emphasis on higher education. Of course, higher education is a wonderful thing for all sorts of reasons. But in some cases it may be at a hidden cost of opportunities lost and career patterns set towards employment rather than entrepreneurship. Even with higher tuition fees, those (we must assume) with the most initiative and ability will continue to spend some years at university. We must work within this 'given' framework.

How can we encourage able young people at university to start businesses? So far we have approached this problem by teaching subjects such Accountancy, Business Law, Marketing, Corporate Strategy and Business Management. These are helpful and can lead to employment of course but studying these things is not the same as actually starting a business. It is like learning all about sex but never dating anyone!

What then, is the answer? One might suggest that any student starting a business whilst at university (which, interestingly enough, some do already. Richard Branson did for example, and I knew a student who started making 'spats' out of fibreglass in his father's garage for Ford motor cars, another who began an internet connection service and another who was planting up an apple orchard with a new breed – to name but three) might have it counted towards graduation – a kind of optional subject. But this would be impossible for university dons to grade. One might suggest that students who start a successful business whilst at university might have their fees refunded or their loans paid off – but 'success' would be impossible to determine on graduation day.

Perhaps we could make use of the observation that students who graduate with a 'first' tend to go on to top jobs. They are the most employable. But students who are likely to be entrepreneurs have their minds on practical matters, struggle with academic work and end up with lower grades even though a 'first' or 'upper second' would mean a great deal to them. So why not require universities to develop schemes whereby any at least 'pass' grade graduate who starts a business whilst an undergraduate and who provides evidence a few years later (say a short report giving turnover figures, annual accounts, growth rates, employment provided etc) of that business succeeding can apply to have his or her degree 'upgraded' in recognition of the study time diverted whilst at university? In a way this already happens sometimes when universities award 'honorary degrees' to outstanding individuals.

Universities should not just be a modern version of the training for the priesthood that they started out as in medieval times. They should be a service to the community – and the community needs more entrepreneurs. Making possible the upgrading of degrees would promote entrepreneurial action in three ways – by legitimising student business start-ups, by allowing them time whilst at university to carry them out and by rewarding their efforts. It would be an important signal of society's priorities. Instead of saying 'we have too many unemployed', we would be saying 'we need more employers'. It would emphasize the fact that each new generation has a duty to provide its own cohort of business leaders.

ANOTHER OIL BUBBLE BREWING?

By Robert McGarvey

There's trouble in oil paradise again. It looks like prices are taking off as political tensions rise in the Arab world. In addition, there is a puzzling spread in pricing between two of the more important benchmark crudes, with Brent trading at wide margins to the West Texas Intermediate (WTI). What the heck is going on?

The extraordinary volatility of oil markets in the past few years has been a function of several major developments: (1) there have been significant changes in the oil '*formula pricing*' regime in the past few years, (2) Index '*securitization*' of commodities has become big business and (3) there is heightened political risk, driving oil and other commodities on an historic run up in prices.

Oil's Formula Pricing Model

The older system for pricing oil contracts was fairly simple. Contract prices were determined by adding a premium to, or subtracting a discount from, benchmark crudes. Generally, West Texas Intermediate (WTI) was used as the benchmark for oil sold to North America, Brent for oil sold to Europe and Africa, and Dubai-Oman for Gulf crude sold in the Asia-Pacific markets.

However in the past few years this all changed when Middle Eastern producers noticed that the spot market was subject to increasing manipulation. Basically producers didn't trust the market so they changed the rules of the game. Instead of using dated Brent as the basis of pricing crude exports, Saudi Arabia, Kuwait and Iran came to rely on the IPE Brent Weighted Average (BWAVE). The BWAVE is the weighted average of all futures (Brent crude) price quotations that arise for a given contract of the futures exchange (IPE) during a trading day. These changes in 'formula pricing' have placed the *futures market at the heart of the Brent oil pricing regime*. So unlike the more spot oriented WTI crude, Brent benchmark is going in its own direction; factoring in the growing political instability in North Africa and the Middle East.

On top of all this, commodity markets tied to the futures market, the Brent benchmark in particular, are subject to a volatility accelerator in the form of *index Speculators*; major institutional investment in the oil futures market, trying to cash in on market instability. Index speculation in commodities is being driven by a potent cocktail of political instability, a lack of confidence in global stock markets and rising commodity prices. Importantly – there are enormous volumes of index speculation sloshing around in the futures market, and after recent events the vast majority are leaping on preprogrammed 'long' positions in oil. The net effect is to drive oil-futures yield curves into the stratosphere in a self fulfilling death march to oil bubble land. I believe we've seen this movie before, a couple of years ago in fact.

BRITAIN, SWITZERLAND, GLENCORE – AND THE EU

By Peregrine Arkwright

The obligation for the United Kingdom to participate in the European Union's $70 billion bail-out of Portugal is unlikely to avoid repercussions among the British electorate, at a time when the UK taxpayer is already being hammered. According to newspaper reports as we went to press, the Chancellor's squeeze on Britain's middle classes is now the most serious for ninety years.

The bailout for Portugal's profligacy comes hard on the heels of similar EU bail-outs for Ireland and Greece. A recent ERC meeting highlighted the financial prospects of Europe's 'PIGS' - Portugal, Ireland, Greece and Spain. On that basis one might perhaps wonder just how long it will be before the UK is called upon to bail out Spanish profligacy as well.

Already UKIP has shown its mettle in European elections. Last May, its supporters almost certainly denied David Cameron an overall majority in Parliament. The inverted consequence was to insert pro-Europe liberals into the Cabinet. It now seems that William Hague's only mistake, as

Conservative leader, in focusing his 2001 general election campaign on Europe, was to have been ten years ahead of his time.

All of which is now adding fuel to a serious debate in Britain about what the continuing benefits of our membership of the European Union might actually be. The *Daily Express*, never a newspaper with any great enthusiasm for Europe, is already running a campaign for Britain to abandon the Treaty of Rome. The argument that Britain would not be allowed to do so is absurd – France has dodged in and out of the NATO treaty on more than one occasion.

More to the point is how Britain might fare if it 'went it alone'. The obvious answer to that is to examine the course of economic events in Switzerland, which has methodically avoided EEC/EU membership ever since the Treaty of Rome was signed in 1960.

Despite its small population, 7.7 million compared with 61.1 million in Great Britain, independent Switzerland has become the most prosperous country in Europe. It has few natural resources beyond hydroelectricity and tourism. It lacks the international fellowship of anything equivalent to the British commonwealth. It operates in four different languages whereas the UK enjoys the massive global advantage of speaking English.

Further evidence of the benefits of avoiding the EU's draconian employment laws, among other things, recently came to light. The comparatively little-known international commodities group Glencore will float on the London Stock Exchange this Spring, and its 485 partners are expected to net an average of $63 million a head when their holdings are converted into shares. It will be the largest single creation of, or rather transfer into, individual wealth for over ten years.

Glencore is headquartered in Baar in Switzerland, although its all-important oil arm and much of its market trading is based in London. It conspicuously avoids EU employment laws by its choice of domicile. Glencore was founded in 1974, a year before the British were invited to vote in a Referendum on the UK's membership of the EEC membership. Since then, it has grown into the world's largest trader in bulk commodities, including oil, copper, sugar, and iron ore. Last year it generated more than $145 billion in turnover, greater than the GDP of New Zealand.

The biggest personal gain from flotation will accrue to Glencore's chief executive, Ivan Glasenberg, a South African. Unofficially it is said he owns about 15% of the business himself, which would equate to $9 billion. If the estimate is accurate, that will put him somewhere round 75th in the Forbes world rich list, about the same as Hans Rausing of Sweden. Yet even Bill Gates, with $53 billion in personal wealth through Microsoft, has not – so far as we are aware – created a further 484 Microsoft multi-millionaires at a single stroke.

Today Glencore controls a network of mines, plants and trading offices that employ 57,000 people in 40 countries. Its London-based oil trading arm owns a fleet of tankers which has more than twice as many vessels as the Royal Navy, itself the largest navy in Europe.

Glencore is an Anglo-Swiss business. Conspicuously the financial centres of the EU such as Frankfurt or Paris figure practically nowhere in its structure but why should they? They have no significance in international commodities trading. In fact they would have very little to bring to the party at all, except of course for their Brussels-driven employment laws which, for example, mean serious trading rooms are nowadays wholly inadvisable in Frankfurt, home of the Euro.

Powerful trading rooms of the kind known in London depend on a high-reward, high-risk employment culture. The familiar 'hire-and-fire' system is impossible in the modern Germany, because of German-European employment laws. That is one of the reasons why Deutsche Bank, pride of Frankfurt, brought its international headquarters to London. It is also one of the reasons there are now 400,000 entrepreneurial French in the British capital. Indeed there are now so many French in the British capital, President Sarkozy is wondering whether London now deserves its own seat in the Assemble Nationale, elected by the London French. The city is now the fifth largest French city in the world. So much for the benefits of doing business within the EU.

Lest anyone think for one moment that Switzerland enjoyed a golden parachute into its privileged position, they could not be more wrong. In the aftermath to WW2 the Swiss were on the brink of starvation, surrounded as they were by either Axis powers or by France, which had been controlled by the Nazis.

Even in 1951, six years after the end of the war, the Swiss economy was still in bad way. One could hardly give the Swiss franc away - it was trading at 12 to the pound sterling. By then the European Steel and Coal Community, forerunner of the EEC, was already in existence.

Contrast today, when the Swiss franc now stands at 1.48 to the pound sterling, making it more valuable than the US dollar (1.64 to the pound sterling). Not bad for a country which has throughout been spared the supposed economic benefits of EEC/EU membership. It does suggest that the doom-mongers who maintain Britain would collapse outside the EU are humming a political agenda, rather than looking at the available economic and financial evidence.

THE IMPACT OF UNEMPLOYED YOUNG MEN IN THE WEST AND OF CHINESE SUPER-BUREAUCRATS IN THE EAST

By Damon de Laszlo

Mediterranean North Africa continues to be in turmoil and the outcomes remain highly unpredictable. While the intervention in Libya seems to be proving successful, it creates many moral and intellectual dilemmas. How brutal does a regime have to be before we intervene as these hugely complex issues are largely indefinable? It is inevitably leading us in the future on to dangerous ground. The problem for the rest of the world is oil supplies and, here the stability of Saudi Arabia is critical. There also should be a secondary worry, and that is the contagious effect of these revolutions on the states on the northern side of the Mediterranean. The unrest would primarily appear to have been caused by unemployment of a generation of well educated young, and steeply rising food prices.

This phenomenon applies equally well to the so-called PIGS. We saw last year serious rioting in Greece and some in France. This summer could see major trouble in other countries, including Britain. Trades Union movements everywhere will be ramping up pressure as Government expenditure is curtailed. In Britain for several years university graduates have found it difficult to get jobs and a number of government employees will swell the ranks of educated unemployed, who will become more angry as they see very little prospect of finding gainful employment.

European governments in general will find themselves more and more unpopular as they fail to meet the aspirations of the electorate. As a generalisation, the last ten years have seen a period of relatively high employment and low inflation for which politicians, while having little real control, have nevertheless claimed credit. Government profligacy and lax monetary policies are now having to be paid for and government, whether it is a dictatorship or democracy, falls into disrepute as the population finds it is having to meet the bill.

Outside the worrying and difficult social problems that the economic readjustment is causing, the good news is that the private economy is beginning to recover in most sectors. Most areas of the US economy are recovering fast. The exception is the building industry; here residential and commercial property was overbuilt, a consequence of low interest rates and lax monetary policy.

The bust in this area will take some considerable time to recover and prices inevitably will continue to fall until the market starts to clear. If you cannot borrow to buy buildings, the price of the asset will continue to decline until you can afford to make a purchase, and in simple economic terms the over supply will inevitably drive down prices. A trip through southern Spain demonstrates this supply and demand phenomenon in stark reality; it is unlikely that the many thousands of apartments standing empty have a chance of being occupied in the foreseeable future.

The West's industrial recovery brings us back to the importance of China's 12th Five-Year Plan. Remembering that China's Five-Year Plans are drawn up by an extraordinary cadre of experienced bureaucrats, unlike anything we see in the West, and that by and large they have a history of successful implementation; these plans should be taken much more seriously by Western governments and economists.

This one calls for a GDP growth of 7%, considerably down on the last five years. The creation of over forty-five million jobs in urban areas and prices to be kept generally stable. There is a call for a rise in domestic consumption and for the service sector output to rise to nearly 50% of GDP; expenditure on research and development to reach 2.2% of GDP; non-fossil fuel power to reach 11.4% of energy consumption and energy consumption per unit of GDP to be cut by 16%, along with a 17% cut of CO_2 emissions per unit of GDP.

On the social front – and deeply significant for the West – it calls for a 13% average increase per annum of the minimum wage and, for good measure, the construction or renovation of 36 million apartments for low income families. This is a flavour of the Plan which goes into extraordinary detail in many, many areas including such issues as the 'complete transformation of its form of economic development'.

The West will no longer be able to enjoy cheap Chinese manufactures and will find China competing more and more for food and raw materials as the country moves up the ladder of prosperity to higher living standards. These changes are not in themselves worrying, but Western governments will have to adjust their attitudes and policies as well as their behaviour to a new superpower governed, for the time being at least, by men who have vast experience and management capability way outside the majority of Western politicians.

The impact of the Japanese earthquake catastrophe will also have huge ramifications on the West. In the US in particular the trend of moving manufacturing capacity from Asia will be speeded up. This trend started a few years ago as changes in Chinese export policy, along with problems in global logistics started to impact Corporate America. Large corporations are having to do rapid reassessments of these supply chains following the Japan earthquake. Globalisation has meant specialisation on a grand scale as well as consolidation of many industries into quite small geographical locations. Quite minor components that may cost only a few pence but are vital for instance to the electronics of modern motor cars, are sourced from a few factories whose raw materials in turn were made in the tsunami affected areas. The full ramifications of this are yet to be fully assessed but the lesson is that there is today insufficient diversification in the supply of critical parts for many industries. This will add impetus to the return of manufacturing to the West – a great positive.

The biggest negative, however, coming out of Japan will be the political impetus given to the Green movement in particular; those who promote fear over reason will take full advantage to promote anti-nuclear policies. This will cause continuing and growing environmental damage from fossil fuels, as well as hugely increasing the cost of energy in the West.

STRAIGHT THINKING ABOUT NUCLEAR POWER

By Christopher Meakin

At the time of going to press, the damage caused to the Fukushima nuclear power station in Japan by the tsunami of 11 March 2011 showed no signs of final solution. The newspapers have been having a hysteria-generating field day. Reports of radio-active water being pumped into the Pacific universally omitted to explain that radioactive iodine has a half-life of six days.

Although the power station at Fukushima was designed to withstand a tsunami of 19 feet, in the event it was struck by a tsunami of 46 feet. Although that sounds massive it is no greater than the tidal range in the

Severn estuary which sweeps by Britain's Berkeley nuclear power station twice a day. Even the tide on the Thames normally exceeds 19 feet.

At the time of writing, no deaths have been caused by the nuclear accident at Fukushima. Yet in 2010 alone, some 2433 Chinese coal miners died in mining accidents, according to Chinese government figures. That averages 47 a week, and the annual total is not far short of the death toll at the World Trade Centre on 11 September 2001. There seems to be a gross double standard in the horror value and political significance of fatal accidents. Yet many might well argue that one man's death is just as important, and no more important, than that of any other.

The fall-out in political terms has been even more serious. The Germans had obviously been watching a surfeit of television from Japan, because in their elections of 27th March there was a big swing from Angela Merckel's Christian Democrats to the Greens. This has been interpreted as a major vote against nuclear power. Whether the German floating voter has done his or her sums on the paltry amount of energy available from renewables alone is another matter. It would take the country back to the 18th century, when energy was supplied by wind, water and muscle alone.

There is another double standard at work. Most nuclear power stations still use technologies devised in the 1950s and 1960s. Yet none of us would tolerate aircraft, or cars, or computers or consumer goods still using fifty year-old ideas. Why should it be assumed that nuclear power stations built from, say, 2015 onwards would have to use such antiquated designs?

It is surely desirable the public and the political perception be brought up to date. Now that the pitfalls of nuclear power station design have been demonstrated by Windscale, Chernobyl, Three Mile Island and Fukushima it is not unreasonable to assume the designers might have some fresh ideas. The problems of nuclear waste could be tackled too. A stream of electrons projected towards such waste could create a heat-generating reaction which was completely fail safe. Cut the stream of electrons for any reason and the nuclear process would cease immediately. It is just one of many possibilities.

The present writer has suggested to the government that it is high time Britain established a Royal Commission On Nuclear Technology. It should be required to report within a year. Its purpose would be to bring political, media, academic and public understanding of nuclear energy potential into the 21st century. Only then could wise decisions about future policy be taken in confidence. It would be a far cry from the television-induced hysteria, just two weeks after the events at Fukushima, which now seems to be dictating Germany's energy policy.

KEYNES THE RETURN OF THE MASTER

By Robert Skidelsky p/b 2010 Penguin Books

This is a fascinating and highly readable refresher course for those who once studied economics but who have now a need to catch up with all the twists and turns through such phases as 'neo-classisists', 'new Keynesians', 'monetarists', 'new synthesisers' and much other such name-calling. Through all this we have tended, especially via the unfortunate mathematising of the subject, to have lost sight of Keynes's original insights which, Skidelsky reminds us, were based on economic actors (businessmen, workers, consumers, governments etc) basing their decisions in the face of uncertainties on conventions rather than rational expectations. Macro-economics should therefore be the study of those conventions and public policy making should be based on enlightened responses to actions based on conventional beliefs so that desirable overall outcomes can be obtained. Outcomes like full employment, a good quality of life and harmony conceived both internally and internationally.

Perhaps the most valuable conviction for the reader from this book is the instruction that university courses in economics should be combined with other social science disciplines (economic history, politics, anthropology and so on). He says 'This would avoid the absurdity of a student being able to achieve a first-class honours degree in economics simply by being good at maths.' (p. 189) Relevant economists today need to be studying conventional expectations of economic actors now which may well be changed from those which Keynes observed in his own lifetime. Turning economics into a study of mathematical models is rather like bankers lending money on the basis of box-ticking formulas rather than getting to know clients as people/to judge their trustworthiness.

Skidelski's thorough interpretation of economic thought is fascinating and valuable. Time and again the reader thinks 'Ah, but what about?' only to find that his question is answered in full in the very next paragraph. The result is a text which is comprehensive and satisfying and is remarkably hard to criticise. Still, there is surely something unaccounted for. Can the 'supply' siders, the Chicago school, the critics of Keynesian economics, at least 'as practised', really not have any substance at all?

Consider an analogy with a garden. The gardener decides what to plant, what to remove, what to trim, how to water and tend, and produces (hopefully) a beautiful result. But this is only possible because of the energy, vitality and natural growth characteristics of the plants involved. Their performance he takes for granted but they are the creative force and the gardener destroys the unwanted to enable the wanted to perform. The behaviour of the plants is predictable and can be relied upon.

Keynes was the skilled benign gardener. Virulent plants (banks, untilities) should be kept under control; weeds (monopolies) extracted; good plants (growing companies, entrepreneurs) allowed to flourish; entangling creepers (trades unions) kept trimmed; pests and invaders (excessive foreign trade) curtailed if disruptive; and uncertain weather (confidence) reduced by watering with government fiscal policy to maintain demand and ensure a steady money supply.

But all this assumes that the plants just keep growing in their predictable ways. They don't get discouraged, lazy, give up, or change.

In practice, during the 'golden age' of Keynesian economic application between 1946 and 1970 the human plants in Keynes's garden adapted in ways which could be called unfortunate. Evolution doesn't allow plants to change quickly, but a generation or two of human beings can intelligently adapt in their individual self interest outwitting the out-of-date gardener. The economics profession observed this and thought they had grasped the point by labelling behaviour as 'rational expectations' but this term has been wholly misleading. Economic actors did not become all-knowing about future events and never pretended to be. 'Rational expectations' is a term loaded with scorn for changing behaviour in much the same way as 'laissez faire' was a term of scorn for Adam Smith's understanding of freedom for enterprise. The label 'rational expectations' led to mountains of pointless theorising and easy refutation by Neo-Keynesians.

Instead of 'rational expectations' we should be talking about 'intelligent adaptation'. Thus, trades unions whose members were schooled in the harsh insecurities of the 1930s and so acted cautiously, were superseded by members whose only experience was of full employment and the welfare state and so adapted to become more demanding. Thus the sons of a generation of entrepreneurs and small business people saw that a job in the public sector was a much more pleasant bet. Thus those who in previous times strove to build a little empire of their company found outlets for that same ambition in striving to expand their Quango, their department, their centres for this and that; in local government, their numbers of staff; their size of buildings; their regulations to enforce. In the garden, the dull plants have been happy whilst the good ones have given up. As time goes by individuals are very good at maximising their chances of rewards as they see them. Thus below the radar, the material on which economics rested, had slowly but surely changed by the 1970s.

Monetarism, far from being the regrettable reversal of Keynes's policies, was the inevitable brake to prevent a slide into inflationary chaos - a winter frost in the garden. But worse was to come, as those that survived ran wild. Skidelski puts it this way 'Keynes thought that, with the separation of management from ownership, public motives would increasingly come to dominate in the conduct of large enterprises. He did not foresee that the private interests of managers would come to take precedence *in both public and private* spheres – a tendency powerfully boosted by the growth of the financial sector. Keynes (like Anthony Crosland in the 1950s) thought that managerial control of large corporations would expand their "public motives". He did not foresee the explosion of the bonus culture, which would give managers incentives to rip off both shareholders and the wider public.' (p. 163)

So here we are, with politicians blindly calling for Spring growth. They have little knowledge of entrepreneurship or of business opportunity. We need a new Keynes, but for the moment we only have admirable historians – like Robert Skidelski – of the original master.

J. B.

DON'T BE FOOLED AGAIN

By Meyrick Chapman, FT-Prentice Hall, £16.95

The world is awash with books explaining why the world financial and banking system went belly-up from 2007 onwards. Many of them were written too quickly by financial journalists simply cobbling text together from their clippings books. Meyrick Chapman is a Cambridge historian, which is promising, and a former investment banker and commodity trader which is even more so. He joined Swiss Banking Corporation to help frame strategy for international bond markets. Even better still, you might expect.

In writing about financial crises it is always wise to take the long view. That means going back certainly into the 19th century, arguably to Diocletian. That way one can spot the main patterns, and only then significant deviations from the norm. A book which is inclined think history began in about 1990 inevitably misses out. After a quick review of the Great Crash of the 1920s via an uncritical look at the works of Galbraith, it uses Japan's problems in the 1990s simply as a speedy stepping stone into the present millennium. So inevitably it lacks intellectual depth, which is disappointing in a historian. Instead we seem to be back, if not to clippings book compilations, then to a kind of personal diary of events. This can be entertaining and enlightening, but it does rather assume the author just happened to be in the right place at the right time.

The other test of such books is the ability to see the big picture. Chapman spends about twenty-four pages explaining the UK and US housing markets, which is more than enough coverage to realise those two countries have a peculiar tradition of ring-fencing middle-class savings. Unlike elsewhere they can only be invested in housing; in Germany because of taxation quirks most people rent. That explains much, especially when one might also note that through its industrial trust banks, Japan ring-fenced the savings of Mr and Mrs Osaka so they went into industrial expansion instead. Surely this difference is relevant to understanding the housing market. An ERC colleague who is an expert on Japan describes the book's coverage of that country as 'trivial'.

International comparisons are vital to explaining the distinctive performance of different economies, and yet Iceland, for example, is reduced to a single sentence of just eight words. Spain has some coverage, while Portugal, Ireland and Greece figure nowhere at all. So much for the four basket case economies of the European Union – Portugal, Italy, Greece and Spain – the PIGS.

So turning from history and geography, one next looks at analysis. Here the book is on stronger ground, but sometimes careless. One section is headed 'Bank write-downs are loss of Western wealth.' Well maybe, but then again one man's loss (the bank's shareholder) is another man's gain (the defaulting borrower who got away with it).

Merrick Chapman's book is written in a snappy journalistic style, a refreshing change from many economic tomes. When he was in the right place at the right time his description of what happened can be good. Whether the whole adds much to contemporary newspaper reports of those events is something only each individual reader can decide.

C. M.

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.