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

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Public Sector Pensions – *Michael Johnson*..3
Are We Using a Sensible Measure of Inflation? – *Chris Meakin*..........10
The Outlook for the Housing Market and the
Implications for the Wider Economy – *James Wyatt*.........................12
How Can Demand Be Less Than Supply? – *Michael Reiss*..................18
The Exchange Rate: Too High for Too Long? – *John Mills*..................21
The Perils of Conservatism – *Robert McGarvey*...................................27
The Reluctant Empire – *David Mahon*...30

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and investment. China buys substantial quantities of rubber and coal from Kalimantan, and the China National Offshore Oil Corporation is one of the largest oil producers in Indonesia. The United States, distracted by wars in Iraq and Afghanistan of questionable strategic value, has seen its position continue to slip in the region.

For too long, Indonesia, Burma and to a lesser extent Thailand weakened their militaries by using them to police and enforce domestic policies rather than preparing them to mitigate the effects of China's growing regional influence. Singapore is uniquely independent in this respect. It has a largely ethnic Chinese population and a very positive relationship with Beijing, and yet maintains deep military ties with the United States and Taiwan.

Wishful Pessimism

An increasing number of Western commentators are predicting that the Chinese economy, hit by poor export recovery, unbalanced domestic stimulation, inflation and stalling economic drivers (such as the property sector), will experience a hard landing in 2012. Such views are based more on anecdote than analysis. China's stimulus package is continuing to provide core momentum to the economy, the property sector is being somewhat disciplined, and affordable housing projects are taking the place of many speculative projects. Aggregate demand for housing remains strong. Off its peak, inflation continues to fall and consumption is robust. Western countries frequently entertain the possibility of China facing economic problems, leading to a reduction in its regional potency. Such wishful thinking is not a substitute for real engagement or the basis of a regional strategy.

All countries will be to some degree affected by the new Chinese empire. If, over the next 30 years, China continues to follow the trends of the last 30, even if it changes at only half the rate, the world will be faced with a far more open and plural society. It would be one of the great blunders of history for Washington, Delhi, Canberra or the capitals of Europe to believe that they must prepare to confront a hegemon whose continued rise would come at the price of their own demise.

China's rise has the potential to bring growth and even balance to a confused and economically directionless world.

David Mahon is the Managing Director of Mahon China Investment Management Ltd.

growth and ordinary cultural weaknesses and strengths. The West may understand China best by identifying the common human denominators and motives that drive the country and are universal to us all.

Standing up to China

China faces some difficult regional relationships as it asserts its claims in the South China Sea. It has struggled in recent diplomatic disputes with the Philippines and Vietnam over the Spratly Islands. These fragments of land, scattered over half a million square kilometres of sea, are occupied by China, Taiwan, the Philippines, Vietnam and Malaysia. The United States still maintains a significant naval presence in the area. Some strategists in Washington, Tokyo and London are already beginning to describe China's uncertain regional stances in Cold War language. Such attitudes are not only premature but miss China's many systemic and economic weaknesses and its growing dependence on the global economy. While China's overseas direct investment (ODI) has more than tripled in the last four years, at 6% of total global ODI today, it is still small. The world once viewed Japan with alarm and, as late as the mid-1980s, some of the more dramatic commentators in the United States talked about the possibility of military confrontation. For a new power to emerge, it is not necessary for incumbent powers to fall.

The relationship between the United States and China will most likely be characterised by deepening economic, political and strategic interdependence in the coming years, which will force the sides to reach difficult compromises and acknowledge a partnership within which the counter-balances will be more economic than military. The currency bill before the United States Congress, designed to penalise China for the low value of the Renminbi, is little more than a windmill to tilt at in the run-up to the US presidential election. It is almost unenforceable and would anyway hurt the interests of American companies based in China.

Sixty percent of China's oil imports and 40% of total imports pass through the Strait of Malacca, which will require China to increase its naval capabilities and forge alliances. China has already made considerable strategic gains in the region relative to the United States. In 2005, Indonesia signed a defence co-operation agreement with China, while at the same time attempting to maintain a degree of independence by courting both the United States and India. Indonesia hoped that their regional naval presences would act as a counterpoint to China's influence. This unlikely alliance has, however, failed to mature, and Indonesia is now significantly more dependent on Chinese trade

PUBLIC SECTOR PENSIONS

Extracts from a talk given by Michael Johnson to members of the Economic Research Council on 5th October 2011

There are few subjects and themes more suited to obfuscation and bamboozlement than pensions. Even if John Hutton's proposals are taken on board in full (which they won't be; they'll be watered down), we're going to be revisiting this subject in a few years time because the cash flow gap is getting wider, and its happening very quickly. The vision I'd like to paint is one where people in this country, irrespective of their sector of employment, have similar pensions based upon their responsibilities and income whilst working.

Pension Affordability

I'm going to talk about the 85% of public sector pensions that are unfunded. That is, the cash is collected by George Osborne at the front door of the treasury from the existing workforce, he runs down the corridor and he pays it out to the pensioners queuing up at the back. So it is paid contemporaneously; there are no assets, unlike personal pensions schemes for example.

Really the reason this subject has suddenly hit the radar screens is that George and his chums have been running up and down that corridor more and more furiously, realising that what is coming in the front door in terms of contributions from today's workforce and employers isn't sufficient to cover what they're actually having to pay out the back door to all the pensioners. In 2005/6, that gap was an irrelevant £100m-200m. The June 2010 pre-budget statement from the OBR forecasted that the gap between annual payments and what is being collected is heading towards about £10.5bn in four years time, and this year it is going to be about £4-4.5bn.

When one looks at the newspapers there is a tabloid scream about the unfunded liability, and that something must be done about it (and they'll throw numbers around that might have a trillion or a trillion and a half attached to it). This is completely useless information. It simply represents some sort of calculation to do with bringing in things from the future into today's language,

or present value. So don't get distracted by the size of the liability, focus on the cash flow gap, because that's what hurts.

The initial forecast was in June 2010, and later that month there was the move to reindex the pensions in payment to CPI rather than RPI. It makes very little difference in the early years, but in the October spending review there was the introduction of expectation of rising contributions, which therefore brings the cash flow gap down by about £2bn in four years time. This is essentially George's gentle shove to Lord Hutton that this was the sort of thing that he was expecting to see in the Hutton report.

Then the budget data from March this year shows it climbing back up again, so you wonder, what on earth is going on? Do these guys really know what these numbers are? You know, a billion here, a billion there, it doesn't really seem to matter. And then finally, the most recent expenditure statistical analyses takes us back up above £10.5bn.

What I want you to take away from this is the cash flow gap is extremely big and growing rapidly, and we're not terrible sure what it is.

Pension Fairness

Now let me talk a little bit about fairness. Essentially we've got a Madoff style pyramid here; we've got insufficient contributions, we've got an ageing population and an ageing workforce that is also shrinking. So going back to that analogy with George running up and down his corridor, he is having to work harder because the pensioners at the back are living longer, there are fewer and fewer workers (certainly in the current environment) at the front-end, and not only that, but there is a wage freeze, so contributions are not going up because wages are frozen. But pensions in payment are not frozen; they are going up with inflation. So you've got this extraordinary cash flow squeeze going on, and that pyramid is falling over in exactly the way that Madoff schemes have fallen over.

The other thing that is going on in the minority of public sector pensions which are funded, which is basically in local government, is that they are increasingly becoming under funded by about £95bn, out of a total liability of £210bn. So that is another pyramid that is beginning to topple over; this is simply not a sustainable framework.

If you look at the figures that have been put together earlier this year by the ONS, the Treasury and the House of Commons Library, they show that for local government pensions the average (mean) is about £4k. That is pretty

lengths to avoid direct conflict. If either nation were to embark on major military adventures abroad, they would likely increase the potential for internal social fragmentation. In the future, however, China may find itself in conflict with the West and India through the proxy of civil conflicts in regions such as Southeast and Central Asia.

The rise of China, India and Asia has caused a shift in economic power from the Atlantic and the Western Pacific to the Indian Ocean and the South China Sea. These oceans connect centres of manufacturing, consumption and vital resources that will define global economic development in the twenty-first century. Alliances will weave bonds and give rise to differences as complex as the routes plied by their merchant fleets.

No other economy in the world can match China's ability to lend money on terms so reasonable that the loans are often practically gifts. Trade with Africa exceeded US$120 billion in 2010, and Chinese loans exceeded those of the World Bank in the developing world as a whole. China is also beginning to replace Australasian and American influence in the South Pacific with 'grants' of cash to Samoa, Tonga and Fiji that do not carry the same conditions as those required by these island states' traditional development partners. In the future, the harbours of these remote islands will prove useful should China need to shelter and refuel its naval vessels. China was among the first countries to recognise East Timorese independence and is now building a headquarters for the East Timorese military in Dili. As China is a long way from developing a blue-water navy, these economic relationships provide it with immediate options for a greater presence in the South Pacific.

To keep in perspective the accusations that China is 'buying' Africa and the South Pacific, 75% of China's outward foreign direct investment went to Asia and the Middle East in 2009; Africa accounted for only 4% of total investment, while the Pacific received 3%.

The best course Asian and Western nations can take to ensure a relatively benign China and peaceful twenty-first century is to maintain their own domestic economic balance and commitment to global commonwealth. Brussels must become more effectual and decisive in governing the Eurozone, and the United States must not let domestic political power struggles and ideological economic debates cripple its ability to stabilise international markets and continue to function as a global economic power. Too few Western politicians understand modern China, and too many surrender to extremes of either ungrounded admiration or suspicion and disdain. The gravest error is to attribute esoteric qualities to China's political evolution, and assume that Chinese culture is so different or even superior to other cultures that it is fulfilling some mystical destiny. China has so far evolved as any nation would in dealing with poverty,

I. The Ming fleet was comprised of at least 300 ships, the longest of which was 122 metres (400 feet). The Chinese force numbered 30,000 men. It is seldom noted in China that on these voyages, Zheng He demonstrated the power of this fleet by defeating large pirate forces in the South China Sea and participating in a war between kingdoms in what is now Sri Lanka.

Today, China's emissaries arrive on Asian and African shores and in the cities of Central Asia not in sailing vessels but as financial institutions such as the China Development Bank, and as state-owned oil, mining and construction companies.

Filling the Void

The increase in China's economic interest in Central Asia has been accelerated recently by a weakened Russia and United States. In 2009, China bought a 50% stake in the Kazakh oil and gas firm MangistauMunaiGas JSC, Kazakhstan's fourth largest, with oil reserves of 500 million barrels. This was accompanied by a US$10 billion sovereign loan. Negotiations to lease 2.5 million hectares of agricultural land followed, but were stalled when met with popular protests. Using only 50% of its capacity, the 2,800-metre Kazakhstan-China pipeline delivered 10 million tonnes of Kazakh oil to China in 2010. China has made interest-free loans to the militaries of other Central Asian countries such as Tajikistan, and invested in the development of resources such as the Turkmenistan-China gas pipeline that has already delivered 14.7 billion cubic metres of gas to China.

China delivered a US$20 million technical assistance package to Nepal's Army in April this year, causing understandable angst in New Delhi. China's US$4.2 billion interest-free loan to Rangoon deepened India's concerns, this time about Burma's increasing economic dependence on China. Existing highway and hydroelectric projects and resource procurement agreements will increase Burma's dependence on China over the coming years. It is not implausible that China will have naval bases in the Andaman Sea before the end of the decade.

The West's use of the remote, blunt instruments of trade sanctions rather than the more laborious and politically difficult path of sustained dialogue will drive faltering states like Burma even closer to China. China also covets the access to Indian Ocean ports that Pakistan can provide, and therefore tolerates the chaos and fragmentation within the borders of its once staunch ally. Although India and China have a sensitive and volatile relationship, restrained by the challenges of managing their domestic economies, they will go to great

small, but that's because most of the people in local government work part time, and they are low-paid, so they are bound to end up with small pensions. The main unfunded schemes are about £6.5k, so that's teachers and the civil service and so on, and if you take the median for the whole of the public sector it comes to about £5.6k. And then if you add in occupational schemes in the private sector, that number comes down to just under £4k, which tells you that public sector pensions are bigger.

"Ah ha!" The unions say, "this is because we get paid less, so its fair, isn't it?"

Well, no, that's just not true. Last year average gross weekly pay in a private sector job was £581, and in the public sector it is £605 (4% more). And if you look at total reward, which includes employer pension contributions, that gap widens to £614 and £692 respectively (a 13% difference).

This is completely misleading, because it doesn't take account of the fact that public sector individuals will enjoy certainty of income in retirement until the day they die. That is not priced or valued in this calculation because they are in an unfunded will. They also don't have investment risk in the way that private sector individuals do.

So to get a handle of what the real differential in the equality of public vs. private sector pensions is I used the contributions as a proxy. The average private sector DC (defined contribution scheme) has contributions of about 12%. This is 8% typically from the employer, and 4% from the employee. I went to half a dozen actuaries and I asked them what an individual in the private sector would have to pay to enjoy the same pension as an equivalently waged public sector worker. The number that came back ranged between about 34%-37% - roughly three times larger, which gives you a measure of the relative value of the private sector against the public sector pension package of someone on the same wage.

Lets have a quick look at one other aspect of fairness before we start talking about ways forward. At the moment, in the unfunded schemes employees are putting in about £5.4bn a year, and employers are putting in £16bn, with the Treasury filling a gap of about £4.5bn. If we take on board Hutton's proposals as they stand, then employees contributions will go up from £5.4 to £7.2bn. The gap in the employer contributions will be almost £26bn, because pensions in payment will be about £33bn. Post-Hutton, the proportion of pensions payments that come from the taxpayer, which is through employer contributions and the Treasury funding that gap, basically doesn't change. The burden on the taxpayer is proportionately about the same.

We've really got a new 80-20 rule coming into place. We have 20% of the working population in the public sector who will, post-Hutton, continue to enjoy certainty of income until the day they die, and that is paid for by the 80% of the working population in the private sector who no longer enjoy that certainty of income. This all makes for an unsustainable framework which translates into the perpetration of generational injustice, because it's the next lot who are going to have to pay for all this. This is at the root of the fairness issue.

What Needs To Be Done

John Hutton's proposals will deliver some very long term, very significant savings. But the problem that George Osborne has got is that he needs quick wins. He needs cash flow savings now; he doesn't need 20 to 30 year savings because they have no political value. The choices that are available to the chancellor are very, very limited.

The only way that George Osborne is going to get quick wins out of this is to dramatically increase employee contributions, and you'd no doubt see the press push back on that. Politically it is extremely difficult to push through, particularly when there is a wage freeze. So he is stuck.

First of all, we need a strategy that puts the unions onto the back foot, and that is to dramatically increase the basic state pension. If we raise the state pension above the means tested benefits threshold and above guarantee credit, we can turn round to the unions and say "Right, you have some legitimate concerns about pension equality. We've addressed them. Now, we're going to talk about how we move public sector framework to a DC world of provision."

People will immediately jump up and say "How do we afford this?"

The first thing that is going to happen is that by raising the state pension above the pension credit threshold, we unleash a virtuous circle because the £8.6bn a year that we spend on means tested benefits by and large disappears, because everyone has been raised above that.

The second thing which is certainly likely to happen in the interests of simplicity is that the second state pension will disappear, and with that, contracting out will disappear, because there is nothing left to contract out of. This is where the Treasury have made some mistakes. They've been talking about contracting out rebates no longer being paid, saving about £9bn a year. The vast majority of that is in the context of the public sector, where the employers are part of the state, so it is circular and internal. By and large, the

some grand strategy of regional and global dominance, would be to misunderstand the forces that both drive and inhibit Chinese expansion. With a huge population in a resource-constrained land mass, China is struggling to lift hundreds of millions of people out of poverty and to meet the aspirations of those already experiencing an improved lifestyle. Because of China's rise, global markets are becoming larger, deeper and more complex. The West's present decline is due to poor commercial governance and greed, not the fact that China is rising.

Although China's supporters commonly make the point that the country does not have an expansionist culture, China's participation in the Korean and Vietnam wars is an example of the lengths it will go when it feels its borders threatened. In the coming decades of strong domestic economic growth China will be forced to protect more abstract, yet equally strategic, economic borders. China's domestic complexity and poverty is and will remain a restraint on any wanton political adventurism. China will, nevertheless, evolve in response to how it is treated in the coming decades; any Western strategy of containment is more likely to bring about the Chinese belligerence the West fears than a positive strategic outcome.

In the last three decades of its re-emergence as a nation, China has been reluctant to engage in global issues or to take overt sides in regional conflicts. It has played a largely passive or neutral role in international organisations and forums, abstaining from votes on major issues and seldom sponsoring resolutions of its own. When China's direct interests are at stake, however, it is quick to act. China deployed its navy to join the anti-piracy coalition in the Indian Ocean, not just to fight piracy, but as a step toward establishing a longer-term regional naval presence.

China is becoming more assertive in Asia. Self-conscious that it will be judged harshly, the Chinese Government has tried to cast its current stance as one legitimised by historical precedent. China once traded freely with other countries in Asia and ranged as far as the coast of Africa, forming commercial alliances and accepting tribute. In 2009 the Chinese Government attempted to emphasise this point through a television series about Admiral Zheng He who, on a series of voyages in the early fifteenth century, sailed huge treasure ships through the Strait of Malacca and along the coast of India to East Africa, and to the ports of Aden and Hormuz. These voyages appear to have been peaceful, demonstrating the power of the Ming Dynasty and its desire to learn about the outside world and to expand trade. The peaceful nature of these voyages was insured by the fact that none of the countries the fleet visited could match its power. No fleet as great was to assemble anywhere on earth until the British fleet assembled at Scapa Flow at the beginning of World War

THE RELUCTANT EMPIRE

By David Mahon

To generate and nourish,
To generate and not to possess,
To act and not to grasp,
To lead and not to dominate:
This is called mysterious power.
Laozi, fifth century BC

In order to ensure its economic security China is increasing its political and economic influence throughout Asia and as far away as West Africa and the atolls of the South Pacific. China is becoming an empire, in the sense that it is systematically establishing an economic and strategic presence beyond its own borders, but it is not doing so as willingly as many of its Western observers assume.

For a country that was eviscerated by foreign powers in the last half of the nineteenth and first half of the twentieth century, China is uneasy about being identified as anything more than a regional economic power. The perception that China is already a hegemon in the region, and certainly an arbiter in global commodity markets, is a huge diplomatic challenge for the Chinese Government.

The Chinese Government is not alone in managing the contradictions between the image it wishes to project globally and its actions to secure resources. The United States has always presented itself as the antithesis of an imperialist nation, criticising European countries, and particularly Britain, for the backwardness of their historical imperialist endeavours. Yet America engaged in its own complex imperialism as it absorbed the tribal lands of the Native Americans, the south-western estates of the Spanish Americans, Hawaii and the Philippines. Nations, like individuals, strive to project images of themselves which relate more to how they wish to be perceived than to who they truly are.

Like the United States in the twentieth century, China will become increasingly influential over the coming decades as it moves to protect its economic interests beyond its borders. To see this as threatening, or as part of

people I meet in the treasury are extremely impressive, and when I pointed this out to them they did, to their credit, turn around and admit I was probably right. The real number by my calculations is roughly £3.9bn, but it is pretty meaningful.

And the third proposal which I'm absolutely loathed for in lots of circles is that we put an end to the higher rate of tax relief. It costs us about £6.9-7bn a year, it goes to the wealthy who don't really need it, and it is not very effective in terms of capitalising the savings culture (which is what we want to do).

Two years forward, we should then compel the public sector to participate in NEST (National Employment Savings Trust, which comes along with auto-enrolment next year). Starting now, 7-8m private sector workers will be auto-enrolled into pensions schemes including NEST. So it's a huge component of the government strategy to encourage people to save, but it excludes the public sector. The public sector should be compelled to participate, and in parallel, we should adopt John Hutton's proposals for a career-average DB scheme (Defined Benefit) for the next 8 years or so, as an interim measure. Then in ten years time, we should go the full way, and say we're going to continue with your NEST participation, and we're going to move you to a notional DC scheme, to replace the CARE DB.

So we've increased the state pension above the means tested benefits threshold, it is unfunded, and it provides certainty of income in retirement. NEST starts to grow (which is a funded scheme), and above that, the unfunded notional DC framework comes into place. This rather curious creature is not a new innovation (it is used by the Swedes and the Dutch and various others), and it gives each individual in the public sector an account with their name on it. The contributions that are made by employers and employees are credited to this account, but the cash flow continues to go to George Osborne so he can keep running up and down the corridors in the treasury.

Allied to that, those pots are given certainty of growth by the employer, so the employer is assuming the investment risk and we can use gilts flat or some other measure, perhaps linked to economic growth. When the individual retires, with his notional DC pot, he then goes and buys an annuity in the market in the way that the private sector does, and he assumes the longevity risk and the interest rate risk and so on that that entails. This is a major move away from the DB structure that we have today, that crucially moves the emphasis of longevity risk (which is the biggest risk that we're all concerned about), from the state to the individual.

What we're really doing here in terms of risk management is that we're taking longevity risk and we're saying the state's capacity to assume this risk

should be concentrated in the state pension only, and therefore is available to everybody on an even terms basis, so that we're all in it together.

Recall that NEST is funded; that means that the contributions related to it are used to purchase assets in the name of the individual rather than going to the Chancellor running up and down the corridors of the Treasury, and this gives rise to a problem because clearly then George's collections at the front door are going to be a bit smaller, so he's got an even bigger problem related to his cash flow.

However, at the moment, we know for sure that contributions in the current negotiations are going to rise for employees. My suggestion is that whatever those rises turn out to be, they should go into the NEST account of the individual, not to the Treasury. There is a concept of thinking in the Treasury called "Spend to Save" that applies here. Ostensibly of course George Osborne would love to get his hands on this cash flow, but he's smart enough to realise that above all else, something like NEST will start the transition towards the disciplines of a funded DC scheme.

This is not easy, but the audit commission thinks that it is actually rather a good idea, and they've written about it. They've been quite clear that they think that funded is better than unfunded because essentially the trade that is going on here from a Treasury perspective is that funded schemes invested in assets should over the long term be able to return something a bit higher than the cost of government borrowing, which is what the government is paying to close that gap.

Crucially, this is all about wanting to capitalise the savings culture. We have 20% of the workforce, many of whom save nothing, and NEST will be the first time they will have a personal account with their name stamped on the front of it to start sowing the idea that saving is a good thing.

This is first and foremost a communications exercise. Its nothing to do with technical whizz-bangs and actuaries and things like that, and therefore the move to the notional DC world needs to be signalled now, so we're giving everyone 10 years notice. Thereafter, and this is "Cameron thinking" talking about personal responsibility, public sector employers have got to become much more responsible for the promises they are making their employees. Therefore I'm suggesting that there are two boundary conditions to what is going on.

Firstly, in ten years time, the Treasury door is locked, so that the cash flow gap is no longer plugged by the Treasury. It has to be done by the employers. They have to assume responsibility. And secondly, I'm suggesting that the cash flow that comes from the taxpayer should be limited as a proportion of the

and soon MS-DOS became Microsoft Windows and the world had a ubiquitous new software operating system for a generation of personal computer users.

Microsoft's ownership of this non-traditional asset, one of the most profitable of the 20th century, was – ironically – only made possible through IBM's ignorance and neglect.

But MS-DOS was not the biggest asset IBM left on the table that day. Customer equity, the magic ingredient that informs the 'Why of the Buy' for computers, soon passed from IBM's hardware to the Windows operating system. Armies of computer buyers flocked to Microsoft based computers regardless of the hardware platform. (Although a note to Microsoft: today customer equity is moving to Apple's platform, beware!). This customer equity asset was, until recently, the most valuable asset in the history of computing. More than anything else it created the global dominance of Microsoft and cratered IBM's computer manufacturing business.

"So, Matthew, there is something new about the new economy. Value is driven in new ways, from unfamiliar, intangible sources that most bankers don't understand. How can bankers hope to keep pace with all these changes? I don't know but burying your head in the sand and pretending that nothing has changed won't help, that's for sure."

Robert McGarvey is a member of the Economic Research Council's Executive Committee

software developer Tim Paterson for $50,000 and adapted it. The renamed version eventually became IBM's PC-DOS.

New Approach to Software

Developing software and selling it outright to customers was standard operating procedure in the software world of that day. In Microsoft's case, however, something quite different happened. Bill Gates pondered on how best to sell his operating system to IBM, but also retain the right to sell it to other customers as well.

Bill Gates launched Microsoft and (almost accidentally) created the modern software industry by ring-fencing his computer code with a legal agreement and licensing its use to IBM instead of selling it outright. Under the agreement Microsoft retained the right to independently develop and market its own version of PC-DOS under the brand name MS-DOS. Signing this agreement was a colossal blunder for IBM. It was an error in judgment that in very short order catapulted this titan of industry to the point of ruin; meanwhile Microsoft, a global superstar, was born.

The lesson for bankers today is this: the launch of Microsoft might never have happened if IBM had not brought an antiquated industrial mind-set to the negotiating table.

IBM, of course, played by the existing rules of business; they **knew** that only tangible assets were 'real'. For IBM, software, an intangible 'service', was expendable. As a result of this blindness IBM didn't see the opportunity or the danger and therefore did not object to the licensing arrangement.

Microsoft Knocks Out IBM

With the stroke of a pen, IBM walked away from two of the most valuable (if non-traditional) assets of the 20th century; they simply abandoned them at the boardroom table. And (bankers take note) what were these assets? The MS-DOS software, and more importantly a relationship-based customer equity asset that would dominate the world of computing for the next quarter century.

Ownership of the MS-DOS software platform soon paid handsome dividends for Microsoft. With its unique capabilities MS-DOS helped launch IBM clones, competitors to IBM in (clone pioneer) Columbia Data Products, Eagle Computer, Compaq and others. This, however, was only the beginning

total pensions in payment, so we're hypothecating the problem within a ring fence to public sector employers. I'm suggesting 65% which is roughly what it is in the private sector – by and large, private sector employers pay 65% or thereabouts in contributions to pensions, and I think that's a sensible yardstick to use for the public sector.

But crucially, how employers achieve this self-sufficiency should be entirely up to them. If they want to cut the workforce, they can; if they don't want to do anything on the pensions front, that's up to them, but then they'll have to adjust their budgets. So then you empower them to make decisions, because this is not something for central government to go meddling around in.

ARE WE USING A SENSIBLE MEASURE OF INFLATION?

By Chris Meakin

In November, the Chancellor announced he was breaking the link between inflation and state pensions. The linkage is one of many such. The rate of inflation is one of the most pervasive determinants of Britain's economy policy. Among them the most conspicuous is the business of the Monetary Policy Committee (MPC), created in 1997 and put under the auspices of the Bank to manage Britain's interest rate. It is required to do so by chasing the rate of inflation.

Is the statistical composition of the rate of inflation up to it? The published figure is no longer just a description; as seen in the work of the MPC, it now has huge prescriptive power as well. The published rate depends on a range of essentially subjective judgements made by the Office of National Statistics. Are the components they use relevant, and are their weightings helpful? Is the economics underlying those judgements realistic?

One thing you can say for the current Eurodebt crisis is that it is exposing the raw fundamentals of economics. The ECB is refusing to behave as a central bank. It is not managing the government paper issued by the governments which use its currency. So what is it other than an expensive eunuch? It is being driven by Germany, where it lives. The Germans seem to be terrified for historic and political reasons of triggering inflation. They have banned the ECB from acting as a Lender of Last Resort.

Whatever the past experiences of Germany, inflation is nevertheless a classic cure for excessive debt. In effect it is a very crude, all-pervading tax on everyone who uses that currency, and either holds it or has granted loans denominated in it. Inflation is meantime a bonanza for everyone who uses that currency and has debts in it, such as a government. So true inflation changes fundamentally the balance of fortunes between borrowers and lenders. In the traditional terminology it is, on balance, a progressive tax. This yin and yang relationship is at the heart of the economic logic behind the MPC.

Too many of the present components of the inflation indices do not, at present, meet the above definition. Many of them will not be influenced by the rate of interest, so why are they in the inflation index at all? What is the point of chasing them with a weapon which cannot affect them? While economic activity at large is affected by interest rate changes, much of 'inflation' is not.

THE PERILS OF CONSERVATISM

By Robert McGarvey

I had a conversation recently with a banker friend of mine, who's sceptical about the 'new' economy ("there is nothing new about the new economy", he claims). While I was ranting on about great opportunities he interrupted and said: "But Robert, we can't bank that stuff, there's no intrinsic value there. Its not real like land, or plant and machinery."

I had to stop and catch my breath for a moment. Apart from the horror of absorbing this shocking statement, I was beginning to see how difficult it is for many knowledge-rich businesses today to get banking facilities – they might just as well be talking to a brick wall.

David and Goliath

After I recovered my composure, I said, "Matthew, let me tell you a little story about how attitudes just like yours almost destroyed the most powerful company in the world."

In the '60s and '70s IBM owned the computer market. It was the biggest and most powerful technology business on the planet. IBM began its life in the 1880's as International Business Machines, and had grown up during the 20th century as a machine-maker 'extraordinaire'. By the late '70s, IBM was unsurpassed in terms of technology development, but was even more dominant in reputation. It was often said in those far away days "*nobody was ever fired for buying IBM*." They dominated the computer market by virtue of their brand reputation and the excellence of their hardware: selling frighteningly expensive mainframe computers.

With success came arrogance and complacency, fatal flaws that were evident in their negotiations with start-up software pioneer Bill Gates. Bill was so young and Microsoft so small in the late '70s that neither registered on IBM's radar screen. Good fortune, however, was just around the corner. Early in 1981 Microsoft was approached by IBM to produce some operating software for IBM's ground-breaking, soon to be released PC, the "Personal Computer".

As it happened Bill and Microsoft didn't have a ready operating system to sell to IBM, so they went out and purchased a basic operating system from

So if there is no change of economic policy priorities away from inflation and towards achieving a competitive exchange rate, we can expect the response to further worsening of our debt position to be exactly the reverse of what is really needed. There will be more cuts, more unemployment and no growth. Unfortunately, however, the need for borrowing will not go down. On the contrary it is likely to increase as neither the country, the consumers, nor the government can make ends meet. This is not a sustainable position. It cannot go on for ever, and it won't. Sooner or later there will be no lenders.

When this happens, the exchange rate will fall uncontrollably. The choice before us, therefore, is not whether we are going to have a much lower exchange rate at some stage. We will. The choice is whether we engineer this in time for the transition to be done in reasonably good order or whether, by fighting a losing battle to the bitter end, we waste huge additional amounts of time and money before the inevitable outcome overtakes us.

What is the point of the MPC prescribing doses of an essentially useless medicine?

Consider the close relationship between oil, or in other words energy, prices and Britain's inflation index. A hike in world oil prices is a tax on people everywhere who use oil, irrespective of the currency in which they work. When OPEC orchestrates an increase in its prices, it changes the balance of fortunes between oil producing and oil consuming countries. An increase in Saudi Arabian spending power is simply balanced by a reduction in, say, European spending power.

That is false inflation - it does not change the balance of fortunes between lenders and borrowers. It is only included in the inflation indices out of mindless habit, a misunderstanding of the economics involved. In no way are world oil prices susceptible to changes in the UK's domestic interest rates, so asking the Monetary Policy Committee to chase them by such means is illogical.

That said, many of the oil price rises lately have been engineered by (profitable) trading mechanisms within the market, and a far better understanding of things like the oil contango should be in the public domain. The key difference is that an OPEC-induced price rise could be for keeps, whereas a market-induced price rise must eventually come down again once it unwinds, and often does so quite sharply. The present relationship between suspect inflation rates and inappropriate interest rates is an economic trap.

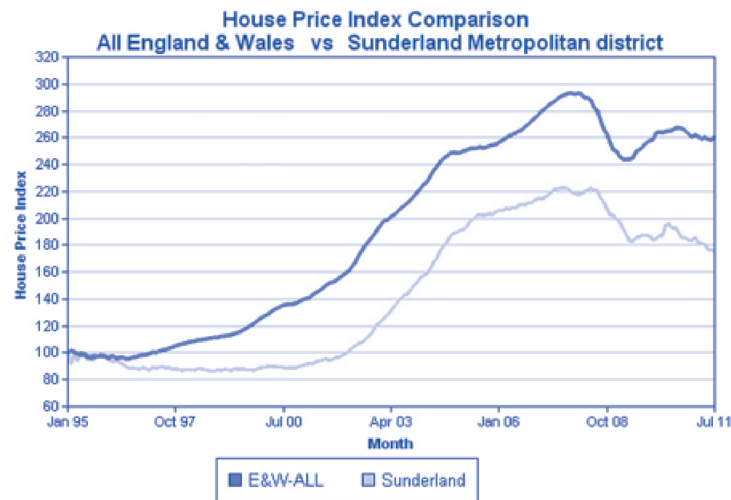
Chris Meakin is a member of the Economic Research Council's Executive Committee.

THE OUTLOOK FOR THE HOUSING MARKET AND THE IMPLICATIONS FOR THE WIDER ECONOMY

Extracts from a talk given by James Wyatt to members of the Economic Research Council on 13th September 2011

When you are talking about property, there's a lot of monetary illusion, in the sense that people don't think in real terms. We ran a survey with the London School of Economics on house price and inflation expectations and amazingly enough everyone thought that inflation would be higher than house price appreciation. So in other words they were telling us that they expected house prices to fall in real terms.

Below are the statistics from the Land Registry. The dark line is England and Wales, and the lighter line is Sunderland. As you can see, both Sunderland and England and Wales are off from the peak.



If you actually look at the figures, England and Wales are down 22.8% from the peak in real terms, averaging a 5.7% annual fall per year in real terms over the last three years. That is, in my eyes, quite a significant fall. Sunderland is down over 33% in real terms, averaging a 9% fall in real terms.

a much lower pound was not only what they wanted to see but what they were determined to achieve. The Bank of England could be instructed to sell sterling and buy foreign currencies. More quantitative easing could be introduced. The government could deliberately increase its deficit to widen the payments deficit unless the parity of the currency fell. The nationalised banks could be instructed to lend more money to businesses, accepting the risk that there might be more bad loans. Portfolio inward investment could be discouraged instead of being welcomed, as it has been. If the credit rating agencies threaten downgrades, they should be ignored because these would help to bring the pound down. All of this is technically feasible but there would be two major obstacles in the way. One would be the attitude of the countries against whom we were devaluing and the other would be the entrenched views on economic policy within the UK and most other western countries too.

Countries like China may well object to losing some of their competitiveness but on mature reflection they may realise that they have little to lose and much to gain from countries such as the UK being in better shape. It is not in China's interest for there to be a massive debt crisis in the West, undermining the prosperity of the world economy generally and the prospects for Chinese exports in particular. Nor is it in China's long term interest to run its present large balance of payments surplus, especially if the foreign exchange thus generated is lent to countries which are never likely to be able to pay it back. China's very rapid growth rate would only be impacted if the UK and other western countries adopted very deep devaluations, which would be much more difficult to achieve than smaller ones. For depreciations of anything up to about 25% against the Chinese renminbi, there would not be much erosion, if any, to China's huge manufacturing capacity. Furthermore, if no international consensus was forthcoming there would still be nothing to stop the UK taking the unilateral actions described earlier. It may be better to achieve some measure of agreement, if this can be done, but it is not essential.

Much larger objections, however, are likely to come from everyone in the UK who is inured to different policy objectives. Politicians and civil servants, who have fought for low inflation and ignored the significance of the exchange rate for decades, supported by the media and academia, are unlikely to change their minds quickly. Importers are bound to oppose devaluation and so will all those who regard cheap foreign holidays as a prize not to be foregone. The City has always tended to favour a strong pound, as have pensioners and others who fear that the accommodating monetary policy and low interest rates which go with low exchange rates may adversely affect them. There is also the fear that a big devaluation will lower everyone's living standards, although there is no evidence that in practice this would be likely to happen.

can do this, we can get rid of our weak balance of payments position which, in turn, is the only long term way to stop the country, its consumers and its government needing to borrow more and more money with less and less chance of being able to pay it back. It will also enable us to have a much more prosperous future. In addition, it will avoid our position in the world sliding downhill as a result of our inability to run our economy effectively. It will also strengthen our capacity to help solve some of the world's longer term problems from a position of strength and confidence rather than weakness and decline.

What would we have to do with the exchange rate to get our economy functioning much better? Some fairly easy calculations provide the order of magnitude of the devaluations which would need to be made to deal with various different objectives, starting from where we are now. The results are as follows:

1) To eliminate the payments deficit, leaving the economy capable of growing at about 2% per annum but with still large levels of unemployment, a devaluation of between 10% and 15% would be needed.
2) To eliminate the payments deficit and to provide enough leeway to allow the economy to be run with a much higher level of demand, producing a cumulative growth rate of about 4% per annum – the world average – a devaluation of between 20% to 25% would be required.
3) To enable the UK economy to move over a transitional period to the growth rates experienced by countries such as Germany and Japan after World War II, or China now – i.e. with a growth rate of about 8% per annum – the pound would need to fall in value on the exchanges by 40% to 50%.

It is important to realise that these parity changes need to be on a trade weighted basis to be effective. If other countries were to devalue at the same time as the UK then even larger devaluations against the non-devaluing countries would be required. The magnitude of the changes needed is, however, an important testament to the enormous lack of competitiveness particularly with many of the Pacific Rim countries, to which Britain is currently exposed.

What would need to be done to get the exchange rate down? There would have to be a major reversal of the policy objectives which policy makers in the UK have long strived to attain. The authorities would need to make it clear that

The point here is that all areas are not equal. Values tend to fall quicker in areas with higher loan-to-value ratios. That's simply because people enter repossession and the market clears. For those that live in London, especially Central London, you've enjoyed a boom. In actual fact, since January 2000, prices in Central London for flats and houses have almost tripled.

I used to be an estate agent, for my sins, and the market is not smooth as it appears in the Land Registry data. It actually fluctuates from month to month, especially around bonus time. We used to know all the telephone numbers of major banks, because we used to know exactly when the bonuses came out (to the day) and very often we used to know the size of the bonuses. Central London has become very City dominated and over the last few years, especially with the collapse of sterling, it's become very foreign dominated.

What's interesting is that prices of large houses in Central London actually started to show a decline, not when Lehman Brothers went kaput, but when the Russian Stock Market closed and oil fell. It was actually a very good indicator of what was about to happen. There was a very pronounced fall and we had two houses on the same side of the street in Belgravia, roughly the same size and in the same condition, and one went at £15.5 million and a few months later the next one went at £10 million. So people say the property market doesn't move quickly, but it does move very quickly, because it's a free market.

But the really interesting price is that of Prime Central London flats. Prices have jumped 80% in two and a quarter years and that's because the Bank of England have debased the currency by about 22-25% in real terms and what we've found happening is that Prime Central London has become a gravitational pull for the world's international elite. The large flats have almost quadrupled in nominal terms in eleven years. They were initially buoyed throughout the early 2000s (up to 2007) by bonuses, but what we are actually now finding is that the money is coming in from foreign sources. The higher up you go, the more this is the case. At prices above £2 million, 50-60% of buyers are foreign. If you go above £5-10 million typically it goes up and you could be looking at 80-90%. There are a few English multi-millionaires buying, but very few.

Why do foreigners want to buy here? Well, there isn't the bribery and corruption, the police are relatively good (apart from the odd riot), and schools and health care are very good. We bought property for an Eastern European last year and what we actually found was that he wasn't going to really live in it himself, it was for his children, because he was going to educate his children here and if everything went to pot in the Eastern European country he came from he was going to come here and his wife and children would be safe.

The Outlook for the Housing Market

The house price to earnings ratio, even with the latest little drop down, is still at about 5.1: well above the long-term trend of 3.6-3.8. The market overcorrects due to debt and excessive inventory. If you look at the Case-Shiller index in America, the market is already down 25-30% and it is expected to drop another 20-25% because of excessive inventory. Based on that, the house price to earnings ratio could drop to less than 2, which would be pretty horrendous for everyone.

But there's more. The market itself is changing, it's a dynamic market. If you look at owner-occupation, there was a recent study by the Social Building and Housing Federation which said that owner-occupation peaked in 2005 at 71%, and they are projecting it will drop to 63% by 2020. If you are living in London, Oxford Economics recently said that the owner occupation is circa 55% in Central London and that will drop to maybe 40% or even lower.

People can't afford to even get on the ladder. Another interesting statistic that I read recently is that the average age of the first-time buyer is 37 and it's going up every year by a year. So when everyone says that the earnings of the average first-time buyer have increased, in actual fact it's because they're much older. They just cannot afford to get onto the ladder.

Everyone knows the Bank of England has pumped £200 billion into the monetary base. But the banks are sitting on it; it's not getting out there (M4 is negative). That suggests that the banks are highly leveraged and they know what's going to happen to house prices, so they need to conserve their capital. While they're trying to rebuild their capital base, it's very difficult for first-time buyers to get a mortgage unless they're putting down 25-30% equity, which a lot of first-time buyers cannot do.

Although as a property person I shouldn't say it, the property market is like a pyramid, with the first-time buyers at the bottom of the pyramid. But if that pyramid has not got a supportable base, as in the first-time buyers, the whole pyramid will slowly collapse and that is what you're starting to see unfold with the house price to earnings ratio falling off.

So are falling prices a bad thing? No, in actual fact, I think they're a very good thing. There are three times as many winners with falling house prices as there are losers. The first-time buyers, as well as everyone looking to upgrade, will all gain. The losers are those who are advanced in years and sitting on a lot of equity who wish to downsize. So the older generation who have to downsize will lose, but they have the most equity. The other losers are

would widen the payments gap to an unsustainable extent. A weak balance of payments position thus makes it impossible to run the economy at full throttle. The cumulative effect of this constraint explains why registered unemployment, running at about 2.6m in the UK during the autumn of 2011, is so high. Actually, however, the registered unemployment figure grossly underestimates the real total number of people who would be willing to work if there were sufficient jobs available that paid a reasonable wage. Surveys show that the total number of missing jobs is nearer 4m than 2.6m.

As deflationary polices bite harder and growth stalls, constraints tighten still further. If any economy has a borrowing requirement which is rising more slowly than the economy is growing – like India does at the moment – lenders can remain reasonably confident that their debts will be repaid. If the debts are rising faster than the growth rate – which is now the position in the UK and much of the rest of the West – as soon as it becomes apparent that this is the case lenders start getting much more nervous. Their reaction then is to try to cut down the amount of borrowing needed, but this can very easily turn into a self-defeating policy. The less borrowing there is to make up the demand deficiency, the more slowly the economy will grow and the less debt servicing capacity the economy will have. Meanwhile the need for borrowing may not go down. If consumers' incomes drop more rapidly than their spending and claims on government expenditure rise faster than before as unemployment goes up, the need for more debt may go up rather than down.

This is the bind in which the UK government now finds itself. Labour advocates reflation, but clearly with a substantial risk that such a policy will cause the creditworthiness of the country to be downgraded. Interest charges would then rise as the lending risks increased, and expansion of the economy would be unsustainable. The Conservative/Lib Dem Coalition is trying to cut expenditure to satisfy lenders that borrowing can be kept under control, but with the heavy risk that growth will disappear completely while more borrowing is still needed. Neither policy looks viable. If we carry on the way we are at the moment, at best we will suffer from years of slow or quite possibly negative growth, rising unemployment, stagnant or falling real incomes, and cut backs in government expenditure. At worst, our capacity to go on borrowing the money we need to plug the unending deficits with which we will be confronted will lead to lenders losing patience with us. Our ability to borrow more money on any viable terms will then disappear, and a really major crisis will be precipitated.

Is there a solution to these problems? There is, but only if our economic policy priorities are radically changed. We need to cease trying to fight inflation as our major objective. Instead, we need to get the exchange rate right. If we

4) Countries with highly competitive exports are very unlikely to find the economic policies constrained by balance of payments problems.

World trade consists partly of commodities, partly services, but by far the largest component- about 60% for most modern diversified economies - is manufactured goods. If any country – like the UK – has a weak manufacturing base, it will therefore tend to have problems paying its way in the world – and indeed we do. In 2010, for example, the deficit on the UK's current account payment balance was about £40bn. This sum has to be raised either by selling assets or by borrowing. It is an accounting identity that any current account deficit has to be matched pound for pound by an exactly equivalent amount of capital receipts.

There is also another crucial problem about a foreign payments deficit. If what we sell to the world is less than we buy, purchasing power gets sucked out of the economy - £40bn worth of it in the UK in 2010. There are three ways in which this can be counteracted to avoid this gap depressing the economy. Either consumers have to spend more than their incomes or the government has to spend more than its revenues or businesses have to invest more than they save. At the moment corporate investment is low and their savings are high, so all the gap has to be filled by consumer and government borrowing. There is thus a direct causal link between the exchange rate and borrowing. If the exchange rate is too high it leads to a current account foreign payments deficit. The only way then to maintain demand in the economy is by consumer and government debt increasing.

Does this matter? Yes, indeed it does, especially if, to keep plugging the deficits in the country's, the consumers' and the government's expenditure, more and more debt has to be created in relation to the borrowers' capacity to repay. Provided lenders are satisfied that, in the last analysis, the debts owing to them will be honoured and in the meantime interest on them will be paid, borrowing can go on going up and up – as it does, for example, to growing and profitable companies. Unfortunately, however, neither countries with weak payment balances, their consumers, nor their governments generate the sorts of income flows which are produced by profitable investments. Very significant constraints on borrowing then come into play.

When the sums owed both by consumers and the government begin to look uncomfortably large, lenders get increasingly unsure about lending to them. They also start to worry about the country's capacity to meet its obligations. To stop the country's current account payments deficit getting too substantial, the economy therefore cannot be run at full stretch because this

the over-indebted and we know there are a lot of people who are over-indebted right now.

I think this is probably going to be the biggest redistribution of wealth in fifty to a hundred years. The housing market is going to correct and that means, albeit possibly not for Prime Central London I hasten to add, that there will be huge redistribution of wealth from the older generation to the younger generation, and this needs to happen. Politically it needs to happen, and socially it needs to happen. So I would say it's possibly a good thing that house prices are going to fall.

Implications for the Housing Market

The implications aren't great for me. Being a surveyor, I've watched our business drop by 55-60% nationally in terms of sales transactions. Even though values have gone up in Prime Central London, volumes are also down by about 55-60%. As volumes continue to fall, agents will consolidate. Already in the commercial property world, King Sturge has been taken over by Jones Lang, Drivers and Jonas by Deloitte, and even in the residential world you'll see much, much more of that. As my CEO said the other day, we don't really care about prices; what we care about is volume and the stamp duty is killing the market. In actual fact, I think if you reduced stamp duty and freed up the market you would have a great many more transactions. There is a huge bottleneck building.

The housing market is correcting, and it will continue to correct. Some people want a short and nasty correction, some long and slow, but banks know that house prices are falling. They know that they've got further to fall but they will need to raise more capital. Basel III comes in at the end of 2018 and before then the market is going to fall quite a bit further. So that means credit is going to be even tighter.

The Bank of England obviously tried to stop a complete collapse and a 1930s depression, but this left the real interest rate at about -4% (RPI). If you want to know why gold is going through the roof, this is a very good reason why. But it shows that the Bank of England is trying to mitigate it and even with negative real interest rates of -3.5% to -4.5%, we're still seeing house prices nationally fall by 5-6% in real terms.

We're looking at a misallocation of resources, and the housing market is deflating. The Bank of England is in a bind; it cannot raise interest rates because nationally prices have already fallen circa 22% in real terms over the

last three years. What else can it do? Further quantitative easing? We've got inflation running away at 4.5-5%, and it's probably going to get worse. There's very little they can actually do to mitigate it.

There's a good quote by Niels Jensen, of Absolute Return Partners, which says, "House prices are, in fact, much more important to the economy than share prices… The (main) reason is that shares are held by a relatively small number of households, whereas home ownership is high in most countries."

More people own houses than own shares directly. It's dinner party conversation; if house prices are falling it's going to have a negative impact on consumer confidence. Probably the most authoritative study, and I recommend it to everyone, is Carmen Reinhart and Ken Rogoff's book *This Time is Different*. It's very sobering but it's worth reading. They show that during or after periods of deleveraging, growth is anaemic and you have bouts of recession which means the Office for Budget Responsibility's forecasts are pie high in the sky. Coupled with anaemic growth, consumer confidence falling, and banks needing more credit, it may mean that the falling market gathers more momentum.

Could fiscal policy mitigate the falling market? Speaking to a number of agents, stamp duty is a very big issue. I was talking to some friends and a lot of them have got children now and they were thinking of moving up and they said they can't afford to move. They're living in houses they cannot afford to buy themselves now because they've gone up so much, but they cannot afford to make the next trade up to a bigger house, because stamp duty at 3-5% is just too much, especially with the cost of living going up. So removing stamp duty, or even lessening it, would lead to much greater volume of sales. You could maybe offset this by bringing in capital gains on principal private residences. It's not something I'm advocating but the government is going to have to do something.

One of my colleagues, who's a very astute estate agent, said that what we actually need is interest rates slowly to increase, because it would encourage people to sell. We need people to put their property on the market. More volume to the housing market means I keep a job, which I'm very keen about, and it would also mean more work for conveyance assistants, mortgage brokers, etc.

THE EXCHANGE RATE: TOO HIGH FOR TOO LONG?

Extracts from a talk given by John Mills to members of the Economic Research Council on 15th November 2011

When inflation took off in the 1970s and monetarism became fashionable, almost everyone agreed that getting inflation down was the top economic policy priority. As a result, all the available weapons were brought into play. Interest rates were raised. The money supply was tightened. Credit was restricted. Unemployment rose – and inflation fell back. Unfortunately, almost no-one was concerned with what all these policies did to the exchange rates both in the UK and elsewhere in the West compared to the Pacific Rim countries. China, which was just moving into the trading world, was at the time barely on any western policy maker's radar screen.

Forty years later, keeping inflation down is still the top economic priority. The Bank of England's target is 2%. The European Central's Bank's is even lower. The US Fed's is about the same. The theory is that low inflation keeps interest rates down and will lead to economic growth. But this is not what has happened. Growth rates in the West are far below those in the East. By far the biggest reason why this has happened is that the exchange rates between West and East which were established in the 1970s have never changed significantly. Concentrating on inflation and ignoring the exchange rate, however, has been a catastrophic policy error for the UK and for the West.

This is because it is the exchange rate which determines, more than anything else, what any economy charges the rest of the world for the output it sells to it. Any country with a low exchange rate – like China – will have four massive advantages over any country - like the UK - with a high one. These are:

1) The competitive economy's manufacturing base will grow more rapidly than the world average and its share of world trade will rise.

2) It is much easier to achieve productivity gains in manufacturing than in most of the service sector, so that any economy with exceptionally competitive exports will grow more rapidly than the world average.

3) Highly competitive economies will benefit from a better spread of employment opportunities both geographically and in socio-economic terms than if they depend very heavily on services.

Another problem with the Austrian argument is the notion that savings must be spent on something that requires work to be done, like building a new factory. There are in fact many things that can be purchased as a form of savings that require almost no work to be produced.

Land, traded gold, shares purchased on the secondary market. All sorts of financial products correspond either to work that was completed in the distant past, work that will be done at some point in the future, or even no work at all. An aggregate increase in the flow of spending on these types of product will naturally result in a fall in spending on products that require work to be done in the present. So even with a constant, or even rising, money supply there can be a fall in the money available for items that require current labour.

High Unemployment For Years To Come?

Politicians everywhere are proclaiming that we must all reduce our debts and they acknowledge that this process may take many years. What they don't seem to realise is that the money supply and our levels of indebtedness are almost one and the same thing. Under our current monetary system reducing debt necessarily means reducing the money supply. The employment outlook for the coming years is therefore rather bleak. This is on top of the unemployment that will necessarily come through public sector cuts.

Is there any way to repay debts without the money supply falling? In a word, yes. You may have noticed that earlier on I said "*most* money has a certain lifecycle"; this is because there is a small fraction of the money supply that does not expire (so called "debt free money"). Our monetary system can work perfectly well with either type. If new debt free money is injected into the system at the same rate or faster than there is net debt-money expiry, then the money supply can be held constant even as loans are repaid. Unfortunately EU regulations currently forbid the creation of additional debt free money, but in the current environment we may need radical solutions. It is time to change the regulations.

Michael Reiss is the author of "What Went Wrong With Economics?"

Deleveraging is the destruction of excess credit or money. It happens; it's not actually economics, it's not politics, it's mathematics. There's just excess credit or money in the world and it's collapsing in on itself. You cannot have monetary growth of 10-11% a year with economic growth at 4%, because it creates inflation in assets.

There is volatility in all asset classes as investors try to preserve capital – interestingly enough I saw a graph the other day and it showed that the FTSE 100 peaked in December 1999 and if you allow for inflation it's by about 63-65% in real terms. So equity markets are suffering, and possibly will suffer more.

I also attended a lecture about a year ago when Kenneth Rogoff was over and he pointed out that people or the population can only sustain two years of austerity, and if you look at Greece for example, they would have to go through austerity for twenty or thirty years. Throughout history it just does not happen; after two years the population revolts, rises up and says, "Well in actual fact the creditors have just lent us too much money, they're going to have to write it down". That's a very important lesson, he said, and what people should be doing is organising the default now.

One of my favourite quotes (although I'm not a great believer in John Maynard Keynes) is that "markets can stay irrational longer than you can stay solvent."

HOW CAN DEMAND BE LESS THAN SUPPLY?

By Michael Reiss

There are some economists who believe that total demand in an economy must equal its total supply. The argument goes something like this: When people sell their produce, they must, almost by definition, receive enough money to buy the equivalent value of other people's goods. Or to put it another way, the sum total of what people earn from producing their stuff, must be enough to purchase the sum total of all the stuff produced in the economy. So the idea of a lack of demand being a cause of unemployment is seen as nonsensical.

The obvious potential flaw in this argument is that people may choose not to spend all of the money that they just earned from selling their produce. The counter argument to this though is that if people choose not to spend a portion of their earnings they must instead save it. But savings are simply used by banks for investment. Savings can therefore be seen as simply spending on investment projects like building new factories or buying new machinery. Thus *saving* is simply *spending* on different types of produce. New plant and machinery are still the fruits of people's labour and so can provide just as much employment as any other type of produce. This is an argument often used by economists from the Austrian school. I shall be returning to this point later, so I will summarise it as follows:

"All earnings must be spent on *something*, even if that spending is in the form of investing in new plant and machinery."

So if the Austrians are right, there is no way for demand to be less than supply.

Another argument in favour of demand keeping up with supply is that it if weren't true, there would be huge amounts of unsold goods building up continuously.

So, we have a clash of ideas: the idea that demand must equal supply clashes with the notion of the "paradox of thrift" whereby too many people simultaneously saving leads to a lack of demand and a downward spiral of recession and unemployment. This idea was popularised by Keynes though it seems it was known of since antiquity.

So who is right, the Austrians or Keynes? The answer is undoubtedly Keynes. There are in fact two separate mechanisms that can lead to a shortfall of demand.

Mechanism 1: A Falling Money Supply

Not many people are aware of the fact that the money supply can fall as well as rise but it most certainly can. This is because our monetary system was designed such that most money has a certain lifecycle. It comes into existence when banks make a loan, and it expires back out of existence when the principal is paid back. During depressions the desire to take out new loans (creating money) falls below the rate at which existing loans are paid back (destroying money). This state of affairs can go on for years, even decades. During the great depression, the money supply in the US fell by around a third.

The fact that there may be a small net expiration of money interferes with the "Austrian argument" made earlier. In a falling money supply environment, *not* all earnings will be spent on something. A small net flow of earnings will be given back as loan principal repayments where the money will expire out of existence. This is where things get a little more complicated. The thing is, if everyone adjusted their prices downward perfectly in step with the falling money supply, then demand could once again be matched to supply. Unfortunately, the economy is not quite capable of coordinating a fall in prices without some companies getting into trouble. The problem is that the fall in demand will inevitably be uneven and nobody will want to lower their prices unless they get a clear and sustained signal that they need to do so. You never see a restaurant adjusting its prices up and down a few percentage points depending on the previous night's demand and you would never see an arrangement where a shopkeeper could have his rent reduced by 2% because the takings over the previous week had been below par. Both of these mechanisms can occur to some degree, but it is not quite slick enough to occur without some companies going bust in the process.

At this point we must address the question of why there aren't piles of unsold goods building up in the process. Surely everything that is made has to be sold, so even if the money available in each round of selling is less than in the one before, prices *must* fall. Indeed this is true. Virtually everything will get sold, but a portion of them will be at newly distressed prices by people whose companies are in the process of being liquidated.