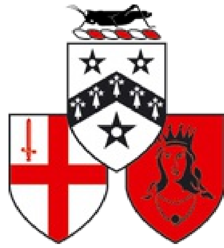

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A New Economic Model for Europe: Building sustainable growth
Transcript

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A new economic model for Europe:

Building Sustainable Growth

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In this lecture I shall discuss something close to Thomas Gresham's own life. He made his fortune by helping Edward VI address the large debts that had been accumulated in the Low Countries through poor financial decision-making. He may well have recognised the economic challenges that the West now faces with the East, although the Low Countries are not, quite as far east as China is. His solution in the 16th Century was to inflate the value of Sterling, and this course of action is probably still very much on the minds of many of our economists and bankers, as a way out of the predicaments that we are in and the themes that I am going to talk about.

However, we need deeper solutions as well, and I shall look at the particular economic challenges that we have designed for ourselves. They bear broad similarities to those in the US, but in detail they are uniquely our own, and they are certainly very different from the challenges and issues of the emerging economies. I think the big challenge for us in the West at the moment is that the crisis revealed deeper problems that we have been hiding within the structure of our economies for several decades, but which have been growing rapidly over the last ten years. They are not going away.

Over the last few weeks, the economic fragility of parts of the EU has again come to the fore, seen in the ongoing debt problems of Ireland and Portugal. Ireland's challenges have as much to do with ongoing problems with her banks, and we must remember that the ECP did strict tests on the European banks less than a year ago and declared them all fit and worthwhile. Therefore, it is more to do with her banks than it is to do with her own lack of prudence in her fiscal affairs. When we look at Ireland and Portugal, they are, in many ways, really quite different economies. Ireland has often been praised during the boom for its controlled public spending, and Portugal, while never as profligate as some, was never praised for its behaviour. Where Ireland is now, it is likely to face a 30% fiscal deficit by the end of this year, if we include the financial sector bailout, while Portugal will get to something like 9%, which is three times the upper limit recommended within the deficit requirements of the Maastricht Treaty. However, in differing ways and to differing degrees, both countries' economic approaches have led to an unsustainable situation, and in the case of Ireland, a large bailout in order to both deal with the local problem and to avoid systemic contagion throughout much of Europe. We do not know whether we have been successful in that yet.

So, the question is: among the variations between differing European economies, is there a particular approach and set of challenges which, in aggregate, are specific to Europe, given the similar, ultimate economic fates of so many of her countries?

At this point, I need to apologise to Germany, who is the major exception to much of what I am going to say. She has survived the crisis with the current account surplus and she has remained a net exporter throughout. I therefore apologise for speaking broadly about 'European problems' that she has, in many instances, avoided.

Clearly, the extent to which each of our economies experiences these challenges varies, but I suggest there are four key areas in particular which define the economic models and frameworks of much of the post-War European social democracy. First, pre-crisis public and private sector debt had already reached unsustainable levels, particularly here in the United Kingdom, and in the face of the increasing exposure to the future demographic changes. Post-crisis, debt levels in much of Europe will often be close to desperate. Secondly, the scale of public sector economic participation is well above the optimum level throughout the EU, reducing our competitiveness in a direct and measurable way, and thereby damaging our unique socio-political aspirations. Thirdly, our public and private savings rates are well below optimum. This removes a major stabilising cushion and pool of investment capital from the economy and it exposes the unfunded nature of much of Europe's public pension promises. Fourthly, our business funding model in the EU is far too reliant on debt, which now seems obvious, but it has been true for a while, and this has led to systemic instability and increased risk and has proved incapable of adequately supporting our areas of greatest economic advantage. In the UK, it was only the emergency injection of 200 billion of equity capital into our economy, in addition to the 200 billion of quantitative easing, that finally stabilised the UK economic situation.

So, to build a European economic model able to compete in the post-crisis world, these four weaknesses will need to be addressed. However, they are only manifestations of an even deeper issue, and that is essentially a political issue, which arises from the interplay between ourselves and our leaders. More and more unfundable promises were and are being foisted on today's electorate, either at the expense of essential investment in the short-term or at the cost of essential funding in the long-term. What we, today's electorate, seem not to understand is that we are simultaneously tomorrow's electorate and we will be called upon to pay the bills at the moment that we can least afford to – in our retirement. Unfortunately, we have stopped having public debates of substance, and we, the people, seem content to allow our Governments to behave in ways we would deem deeply unwise for our own finances and deeply improper for our corporate finances. Therefore, I welcome the Coalition's attempts to deal with some of these issues, but we are at an early stage and, however difficult it gets,

they should have our support.

Allow me some observations on the credit crisis. Among the mountains of books published on the events of the past three years, one of the biggest sellers was a reprint of Galbraith's classic on the Great Depression. The City is fond of saying that a crisis occurs when the last person to remember the last one retires, and that rule certainly would have applied this time. But there is a risk that this historical perspective prevents us from learning an even deeper lesson. Unlike previous Western crises, the credit crunch was not just a market correction for an indefinitely expanding economy, it was a brief tremor, an early warning of a much larger economic event: the emergence of the new economies, of China and India in particular, on their journey to becoming the world's major economic powers.

In 2009, the world economy contracted for the first time since the Second World War, by 1%, and it was widely reported as a global financial crisis. The UK and German economies fell by 5%, but China continued to grow at nearly 9%, and India continued to grow at nearly 7%.

The expansion of China and India, I suggest, is deeply welcome, and it heralds a whole new age in world economic terms, and a whole new age in knowledge development for the global society, but it is a change that we must learn to deal with. It is not short-term. Deutsche Bank, for instance, estimates that, while the GDP of the eurozone's sixteen core countries will expand by a little over 90% by 2030, China will be expanding by 840% during that same period. So the crisis represents an historical moment, at which the imbalance between the established and the new economies became unstable. We can go further than that and say that the crisis was, in some part, only possible because of these transitions. Excess private and public leverage, the credit that crunched, was significantly funded by imported credit from China and the other new economies. This does not mean that this crisis was inevitable, or that the new economies were at fault – it was not, and they are not. It was the combined political, regulatory and commercial failures of the West within this context that led to the current problems.

By 2008, China's trade surplus was 270 billion US dollars a year. When you combine that with the Middle East, we find that they exported over three trillion dollars of surplus savings back to us in the West in the years leading up to that crisis; these stocks of credit came from the proceeds of exported consumer and industrial goods from the new economies to the West. In effect, China was lending us money to buy their television sets.

So, against this background, let us return to the first and second core points that state participation and spending in the European economy has grown both uncompetitive and unsustainable.

Between 2000 and 2009, public spending in the UK rose from £343 billion a year to £665 billion a year. The ratio of public and private sector debt to GDP in the UK is now higher than any other major economy in the world except Japan. Across the EU, it rose from 45% of GDP to 51%. By comparison, the United States had seen spending grow from 34% to 42% – that is below the European levels, but it is an historic increase in US terms. It is one of the ironies of the last two decades of US political life that fiscal prudence was given to the US by the Democrats, and fiscal imprudence by the Republicans.

This shift is measurably damaging our international competitiveness, government spending impacts and economic growth, in a number of negative ways. It reduces innovation, in line with a loss of opportunity for competition. It leads to suboptimal and distorted allocation of economic resources. The state is a less efficient service-provider as it does not experience competitive pressures. Many forms of state spending disincentivise economically optimal decision making, and civil servants and politicians do not acquire management skills in the same manner as the private sector. But of course, there are many spheres of state influence which we all agree are necessary, which create profound collective good and provide services fundamental to an advanced modern state. So, there are deep political questions about the role and extent of the state which we need to be revisiting, questions of the balance between social and economic goods, and some of these are at the heart of the societal differences between the EU and the US. If we choose to extend Government spending beyond well-established limits of prudence, we have to accept the loss of wealth-creation capacity and, as importantly, when we spend beyond our current, sustainable capacity, we will damage the future. It is probable that this is a position now reached by most or many EU nations.

Now, I am not going to deal with the political questions of what individuals can expect from the state, but instead I will concentrate on the economic questions and, to put it in economic terms, to examine the point at which the marginal benefits of Government spending and the marginal costs to growth, employment and innovation intersect.

The academic literature - which includes the European Commission, many famous universities and think tanks - suggests that the optimum amount of state participation in the economy is around 35% of GDP. This is the key point beyond which public services cease to improve in any significant way and the economy is gradually weakened. MIT economists estimate that a GDP percentage point increase in state spending leads to a loss of approximately 0.1% of GDP growth.

These models suggest that Europe should experience a loss of growth, in comparison to the US, as a result of our higher public sector participation, and they are supported by the real world data. The EU 2009 Government spending of 15 percentage points above that optimum would imply a growth reduction of around 2.2%. The US,

by comparison, should experience a loss of around one point, 1%. The actual gap in 2009 was 1.4%, and in most years, the gap between the two blocks of economies was in line with the theory, at just over 1%.

As the Government is now finding, and as many commentators have said, the balance between social cohesion and growth is a delicate one, and we do not alter it lightly. But the data clearly show that our Government spending is too high and strongly weakens our ability to compete.

Let us look at the debt figures as debt itself. The official public figures do not tell us the full story, or the full extent of our debt, which is significantly worse and even more damaging than most of the public discussion implies. Governments of all shapes consistently decline to implement generally accepted accounting practices, although those are their committed formal protocols and the practices that are forced on commercial firms. As a result, they leave literally trillions of Euros of liabilities off their balance sheets for the public discussion. As spending has increased, European debts and deficits have expanded to levels which are literally economically dangerous.

In the case of the UK, our Government claims that net debt grew from 31% of GDP in 2000 to 37% in 2007, but by April this year, it had hit 54% of GDP (if we exclude the direct costs of bank rescues). However, if we include those rescues, as well as the off-balance-sheet spending on PFIs, the £1.2 trillion of unfunded public sector pensions and the further trillion to two trillion from the promises made within the various forms of social contract in the insurance fund, we come to a total potential liability exposure for the UK of £4.9 trillion. This is 370% of GDP, which is the number that you would see on a commercial company's balance sheet after it had been audited by public auditors.

The European economic model has relied on an expectation of perpetual growth, enabling the funding of today's spending alongside promises based on tomorrow's wealth. If this was ever a rational assumption, we can begin to see that it is probably not rational anymore. Again, in the investment sector, the model is called a ponzi scheme, and we literally put perpetrators in jail.

But we are not alone in this problem. We are all at it. In the US, the hard-fought fiscal conservatism of the 1990s has been eroded over the last few years, with a 1.5% surplus in 2000 slipping to a 3.5% deficit in 2008. They reached this point through a different, more complex route than we did. They started making advances for their Medicare system, they had the significant cost of their Middle East wars, and then, they introduced major tax cuts, which reduced the tax revenues from 20% of GDP to 15% of GDP. By way of contrast, Europe has tax revenues of 40% of GDP. On average, our fiscal deficits have increased to 2.5%.

If we add or look at these numbers in the light of the concern of the approaching impact of our aging society, then the likelihood is that we are leaving a large portion of these costs to our children. That is not what is happening in the new world. In new economies such as China, which I know well, they are competing from an initial position of a financial surplus, low debt, future labour supplies and people entering the workplace, measured in the hundreds of millions, as their urbanisation programme continues. At the extreme of what might be considered affordable public sector spending throughout Europe, the figure is €7.3 trillion. These figures reflect the fiscal implications of the credit crisis, but they are just the official figures, ignoring all the others that I just gave.

If we look at the impact of the demographic time-bomb for the EU, through a simple example here in the UK, there are currently 11,000 people aged over 100 in this country. In 50 years' time, we expect that number to rise to 350,000 people, equivalent to a city the size of Coventry. Across Europe, the cost to the public purse of an aging society is currently predicted to increase by 40%. The dependency ratio, which is the number of people in work to support each person retired, is currently 4:1, and that is going to halve to 2:1. As we have said, the costs of those in retirement are largely unfunded.

Nor are we privately saving enough to fund the cost of longer lives. The OECD assumes that pension savers need to achieve an income replacement rate of 70% to live comfortably. We are currently facing a savings shortfall of around €2 trillion a year, or 26% of GDP.

The position has grown much worse over the last ten years. In the UK in particular, there has been a large-scale withdrawal of Government support for pensions, so that the money can be spent today. I have just mentioned the emerging demographics. The investment markets performed, through a series of crises, very poorly for a decade. The major accountancy changes that we introduced over a decade ago have enormously increased the volatility and risk for companies of having pension liabilities on their balance sheets. As a result, corporations are withdrawing their support from the field of pensions' provision, having an enormous impact.

In contrast, China had relatively low pension expectations, and is currently spending 2.2% of GDP on pensions, perhaps rising to 2.6. The overall cost of aging in China is going to increase by 65%, but from a very low base, and it is likely to reach a figure that will still be less than 7%. The one-child policy has unquestionably distorted China's demographics, and the number of people in work in China is also going to peak at some time over the next 20 or 30 years - a peak of 900 million working people, which will decline to 800 million by 2050. However, during this process of urbanisation, nearly 500 to 600 million people in the rural countryside, not yet part of the modern economy, will be available to join their economy. When I was in China two months ago, they were talking about the conscious design of many cities of 50 million people each.

So, widening our evidence base to include non-public debt, Europe, with the exception of Germany, is carrying more debt than any other economic block in the world. In the UK, official statistics – both public and private – show it to be 380% of GDP. In Spain, France and Italy, the figure is 340 to 300. In the United States and Germany, it is below 300. In the new economies, the total debt of China is about 160% of GDP; in Russia, it is about 70. Admittedly, they have their own issues and challenges, but their ability to absorb fiscal shocks, their ability to deal with new crises, and their flexibility for changing patterns of behaviour in the future are far greater than our own.

The other thing that we have done is import our credit, so we ourselves are unfundable in terms of our spending. French, Swiss and German public and private sector debt is now 50% owned by external creditors. The central region contagion is such a fear in the EU that the cross-holding of debt across national boundaries means that an event in Ireland is a pan-European event. By contrast, in the United States, external debt through credit is only 20% of the economy; in Japan, it is 10%.

That leaves us to European savings rates, which, again, have been declining rapidly over the last ten years. Now, from an economic perspective, domestic national savings are generally a good thing. They are a primary source of reinvestment into industry. Without them, an economy is forced to import credit, in the way that I have described. At a household, they do all the things that all of us in this room understand, providing buffers and protections against all sorts of contingencies.

From 1995, the EU saw savings rates fall by a third, from 16% to 11% of disposable income, on average. In the UK, over the same period, we saw savings rates fall from 10% to 1%, and in the middle of the crisis, they went negative. In comparison, in China, savings rates are around 40%.

The first observation to be made is that these low savings rates and depressed returns are, again, insufficient to meet the future needs of our population; again, foisting the payment for our liabilities onto the next generation.

It is a tough time to be saving. We face historically low interest rates, making short-term saving all but thankless. We face a range of tax distortions, particularly in relation to any form of savings in equities, which are the closest measure in access to the growing economy weakening any of us as individuals can get. Those tax distortions, coupled with the accounting changes, have brought about a large scale de-equitisation of the pension portfolios; they have removed a great slug of equity finance for companies and individuals looking for investment, because the equity finance of companies and the equity investment from individuals are two sides of the same coin. They are fundamental to economic growth and prosperity in a modern society.

Therefore, we need to think very carefully about the solutions which will deliver safe investment returns and put capital to work to fund economic growth. Our systems of accountancy, customer risk profiling, and our inability to overcome the predicable irrationality leading most of us to underestimate how much we will need in the future – all of these, one way or other, need to be dealt with.

The fourth and final defining characteristic of the European economic model is that of business and government funding, which has grown excessively reliant on bank lending and is quite unlike the United States. Much of this is good but, in the eurozone, has developed into the largest market for bank finance in the world, with $21 trillion lent by banks each year, in addition to the five trillion lent just within the UK market. However in comparison, the UK equity markets are massively under-developed, in comparison to the United States, and we see that the money raised on the primary markets in the EU is five times less than the money raised for equity investment in corporations and the wealth creation of our society – five times less than it is in the United States. This balance between debt and equity is deeply important to the overall efficiency and safety of both the economy and our individual companies. Efficient capital markets are central to a thriving private sector. They are part of a funding environment able to offer a choice of capital-raising mechanisms suitable for different stages of the business cycle. If bank finance becomes the only or the overwhelming principal source of funding, it effectively becomes the principal risk capital provider and takes on the *de facto* ownership risks. Rationally, what then happens is that the banks will price accordingly and the cost of debt rises to meet equity.

However, within this funding distortion we meet the impact of taxation, and we see commentary from the IMF, the World Bank, and the McKinseys, all saying that the monetary, fiscal and regulatory environments throughout the West systematically undermine equity finance in comparison to debt. We give interest relief, in a nutshell, on debt, and we tax equity finance four times through its lifecycle.

So, if we look at the overall impact on funding, and compare it with the United States, 18% of business finance is delivered through bank debt in the United States; in the UK and across Europe, the weighting is closer to 50%. For all you theoretical economists, Europe has, in a sense, walked away from the Modigliani-Miller model. It has ceased to be relevant to our thinking about how we raise finance. We will need to rectify this if we are to compete. Half of the new private sector jobs generated in the recent years in the UK have been created by the fastest 6% of businesses, and they are all in the small and medium size enterprise category. In much of Europe, early stage businesses are twice as likely to be invested in high technology sectors as their Chinese peers. Blue chip manufacturers have the internal and advisory resources to find efficient routes to capital and the buying power to secure good value, but many of the smaller companies are pre-profit for long periods of time and they have few tangible assets from which to secure a loan. As a result, they are often unable to achieve debt financing either, but they need the support of specialised capital market infrastructure to make the transition

from concept to commercialisation. Again, the United States does this so much better than we do. Our current system is proving really insufficient in this regard, and it is of huge concern that, while 3% of SMEs have access to equity capital, 55% of SMEs use their credit cards as their primary source of funding, at interest rates in excess of 19%. The complexity and costs of equity capital-raising are beyond the average small company management, and so we need a deep re-think about the provision of financial market infrastructure throughout the whole of Europe.

To conclude, I have defined the four key areas in which Europe is in relative decline as a centre of global economic influence: first, unsustainable public sector spending and the growing impact of our aging population, coupled with massive hidden liabilities, which will have to be paid for by future generations: second, high levels of state economic participation, which is crowding out growth and innovation and leading to economic deserts in many areas of the UK; third, low savings and investment behaviour, which removes a major stabilising force and potential pool of investment capital from the economy, and it jeopardises the retirements of many in the private sector, and it places large, additional tax burdens on all of us, for the forward unfunded state sector pensions; and, lastly, a business funding model too reliant on debt.

The issues are hugely complex and politically challenging, but they must be addressed. The current Government needs our support in making some difficult, but necessary, reforms, and I hope that when you next listen to George Osborne, you do so from a different perspective.

But we should also be clearer about the extent of what is achievable. If we rectify this, as we re-emerge, Europe will be in a position of relative economic decline in global terms. This is nothing to be concerned about, but there is no return to a position of economic dominance or a position from which you might be able to get your way by force. Today’s European economic model could be characterised as a blend of what we might call the Anglo-Saxon model and the post-War social democratic tradition. The current balance has tipped too far towards the latter and it requires some correction.

As we start working towards building a new model, I can think of no better starting point than Friedman’s observation that “…the greatest advances of civilisation, whether in architecture or painting, in science and literature, in industry or agriculture, have never come from centralised government”. Our economic future relies on freeing the phenomenal power of individuals and private endeavour within the common socio-democratic framework of the European political union. Thank you.

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