G R E S H A M COLLEGE



ECONOMIC DESTABILIZATION

Three lectures given by

PROFESSOR WALTER ELTIS MA DLitt Mercers' School Memorial Professor of Commerce

Lecture 1 - 6 March 1995 HOW BANKS DESTABILIZE

Lecture 2 - 13 March 1995 HOW NATIONALIZATION DESTABILIZES

Lecture 3 - 20 March 1995 HOW PROTECTION DESTABILIZES

GRESHAM COLLEGE

Policy & Objectives

An independently funded educational institution, Gresham College exists

- to continue the free public lectures which have been given for 400 years, and to reinterpret the 'new learning' of Sir Thomas Gresham's day in contemporary terms;
- to engage in study, teaching and research, particularly in those disciplines represented by the Gresham Professors;
- to foster academic consideration of contemporary problems;
- to challenge those who live or work in the City of London to engage in intellectual debate on those subjects in which the City has a proper concern; and to provide a window on the City for learned societies, both national and international.

Gresham College, Barnard's Inn Hall, Holborn, London EC1N 2HH Tel: 0171 831 0575 Fax: 0171 831 5208 e-mail: enquiries@gresham.ac.uk

How Banks Destabilize

Before the introduction of 'Competition and Credit Control' in 1971-72, the UK clearing banks had an extremely conservative portfolio structure. They maintained cash reserves of 8% of total deposits, and liquid assets of 28% of deposits. They lent at between half and one per cent above the Bank of England's bank rate and they were occasionally ordered to restrict their lending. Credit was in effect rationed at up to 1 per cent above bank rate (which was often a negative real interest rate, as it was during the latter half of the 1960s). With this rationing of credit, loans were extremely secure because banks could limit their lending to the highest quality borrowers.

Depositors received 2 per cent below bank rate, that is a negative real rate of interest from 1966 onwards. Other banks not subject to the London clearing bank's restrictions came in and paid far higher deposit rates and lent at far higher overdraft rates to businesses which could not get sufficient finance from the banks. Some of these collapsed, and depositors were shown queuing to recover their savings.

As for the banks, their deposits were totally safe because of the highly conservative liquidity ratios. But they were handicapped in competition with the unofficial banks because of the obligation to maintain an uneconomic level of liquidity.

This was established after the disasters of the 1930s all over the world. 8000 US banks collapsed, there were major collapses in Germany and Austria. There had been substantial collapses in Britain in the early 19th century (Thomas Love Peacock's 'Paper Factory') and the Italian banks were nationalized in the 1930s with the result that the government acquired between one-quarter and one-third of the equity shares of Italian Industry. The UK clearing banks did not hold equities because these were subject to such vast fluctuations that they could undermine the viability of the banks as they had done in so many other countries. British banks in 1971 were as safe as any in the world, and government had complete control over their aggregate lending and therefore the total extent of bank deposits.

In 1971-72 and subsequently in 1980 all these restrictions were dismantled. In 1971 overall liquidity ratios were reduced to 12¹/₂ per cent of deposits plus cash in tills. In 1980 required liquidity ratios were reduced to a wholly nominal ¹/₂ per cent. The banks themselves were therefore entirely free to determine their ratios of liquidity to deposits, apart from the requirement to meet the Basle capital adequacy ratios. Bank rate become minimum lending rate in the 1970s and it was replaced by bank base rate in the 1980s. Banks could lend at rates far above this. They also began to invest heavily in equities holding these through separately established companies. Now of course they also hold extensive derivatives.

Because whatever banks do is subject to their commercial judgement (subject to overall supervision by the Bank of England) they are more profitable and more vulnerable. The

market for loans is competitive, the UK clearers competing with a vast range of UK and foreign institutions for deposits and loans.

The building societies used to be restricted to lending for housing, and they are being freed to hold other kinds of assets so that they can compete with the clearing banks on level terms and this will increase their vulnerability. The US Thrift and Loans lost vast sums and they were bailed out. Anyone who controls lending policies and is free to lend to those who impress him can make wholly unsound (and/or irregular) loans which destabilize the bank and therefore the integrity of deposits. The danger is compounded in a promotion structure where those who make the most loans appear the most successful and gain promotion to determine who will be made redundant when the loans subsequently prove unsound.

The macroeconomics of this credit system was best described by Wicksell. The absence of a required and regulated (by the central bank) cash base means that the banks can in effect create their own reserve assets and therefore determine their own rate of expension of advances. As advances become deposits, the banks are free to determine the rate of growth of broad money. This will be faster the lower the rate of interest.

If interest rates are set too low for exchange rate or other reasons, bank lending will grow far faster than any target rate of growth of nominal GDP. This will produce booming house and property prices, imports will be sucked in and savings ratios (which are the saving of the of the prudent less the dis-saving of the imprudent) will fall. The result will be a consumer, housing and property boom, as in the Chancellorships of Barber and Lawson which will feed on itself for a time. The escalation of property prices will appear to justify the lending. As inflation accelerates, partly because of the excessive rate of monetary growth, a crisis will force up interest rates, and the subsequent collapse will severely damage the economy, and if regulation has been inadequate, some of the banks themselves and their depositors.

Derivatives are no particular element in this macroeconomic destabilization story. They appear to be a zero-sum activity where some gain and others lose. Some banks will be undermined but others (not necessarily in the UK) should gain correspondingly.

The real risk of macroeconomics destabilization comes from excessive or inadequate monetary growth due to too high or too low a rate of interest. In the 1950s and the 1960s regulation limited the damage caused by an inappropriate interest rate. Now its effect can be overwhelming.

© Professor Walter Eltis

How Nationalization Destabilizes

China, Russia and other East European economies are being destabilized by the losses and borrowing needs of their state owned companies. In Italy they produce with huge deficits which strongly contribute to escalating Italian public debt. They also threatened to destabilize the British economy in the 1970s.

Economies have activities which produce no marketed output such as defence, the police, public health, public education and expenditures to support personal welfare. In a typical European Union economy these absorb between 40 and 50 per cent of output. This means that the sectors which market their output, at home or overseas, in industry, agriculture and commerce can consume and invest no more than 50 to 60 per cent of their output. The remaining 40 to 50 per cent must be taken from them and made over to soldiers, policemen, doctors, nurses, teachers and the socially dependent, via direct or indirect taxation, borrowing or the effect of money printed by the state and paid to teachers, etc.

Private companies typically provide surpluses of the required extent, 40 to 50 per cent, which can be made over via taxation to provide for military and welfare spending.

But state run companies frequently provide surpluses of only 10 to 15 per cent of their outputs for the rest of the economy. Their costs commonly exceed their prices, they have large investment needs and they are frequently run with heavy losses. If they cannot provide adequate surpluses over their own consumption and investment from market sales they will be dependent for their finance on the surpluses of others instead of being in the sector of the economy which helps to finance welfare. Credit Lyonnais is currently costing the rest of the French economy between £10 billion and £15 billion. Air France is costing between £1 billion and £2 billion. They cannot finance French hospitals: they are among the French hospitals which require finance from the rest of France. In Russia and China between one-half and three-quarters of all companies are in the state sector and many like Air France and Credit Lyonnais are part of the welfare state.

In the UK in the mid-1970s the UK public corporations only covered 50 per cent of their costs from market sales. The rest were financed by subsidies and public sector borrowing. If private industry and commerce had been run in the same way, no surplus would have arisen from industry and commerce to finance social welfare. Doctors and nurses, teachers, generals and civil servants would have had entitlements to consume because the state would have paid them, but there would have been no domestic production to match their consumption. This would have had to come from imports. Because the workers of private and public industry and commerce were absorbing all that they produced and exported no more than the imports they themselves required, they would have provided no surplus for social welfare and defence. These would then have had to live entirely off overseas output with a consequent current account balance of payments deficit.

The formula that best describes this is:

(Proportion of marketed output produced by private sector) x private sector rate of surplus

plus

(Proportion produced by public corporations) x x nationalised industries' rate of surplus

equals

(Proportion of marketed output consumed and invested outside market sector)

plus

(Proportion of marketed output exported less that imported)

If the market sector is half private and half public and the private companies produce a surplus of 40 per cent, and public companies a surplus of 10 per cent, the market sector's average rate of surplus will be $\frac{1}{2}(40\% + 10\%) = 25\%$. If the non-market sector, health, education, defence, social welfare, etc., absorbs 35 per cent of marketed output, when the market sector surplus is only 25 per cent, imports will exceed exports by 10 per cent of marketed output. Foreigners will have to provide the marketed output the nationalized industries are failing to make available to the remainder of the economy.

Foreign savers and foreign governments and the IMF would finance this up to a point, but debt would escalate and after a time foreign lending would dry up, or else amount to no more than interest on what the unfortunate country had already borrowed.

After foreigners cease to finance the needs of social welfare which domestic companies are failing to provide an adequate surplus for, only domestic borrowing and money printing remain, and the destabilization these cause was discussed in previous lectures. Growing domestic state indebtedness and inflation soon follow.

Nationalized industries fail to produce adequate surpluses to finance social welfare for two principal reasons.

1. Nationalized companies are in any case regarded by many as part of the welfare state.

They have a multiplicity of objectives of which cost minimisation and profit generation are given insufficient weight.

- a. They are expected to assist regional development so they are located uneconomically. The Macmillan government preferred two inefficient steel mills in Wales and Scotland to one large efficient one.
- b. They are expected to solve unemployment problems, so they cannot easily shed labour when demand falls.
- c. They are expected to support domestic industry so they cannot buy the most efficient capital equipment.
- d. They are expected to advance domestic technology. In the 1950s, to establish nuclear power, the UK spent 3 per cent of GDP to produce 3 per cent of the UK's electricity.
- e. They are expected to set the lead in bringing inflation down. Nationalized companies had their prices frozen by the Heath government to stop inflation "at a stroke".

2. Nationalized Companies also suffer from X- Inefficiency

Managements have many motivations, (i) to make high profits for their companies, (ii) to have undemanding work conditions (on-the-job leisure), (iii) to have equable and pleasant relations with colleagues and employees, (iv) to have comfortable office conditions and pleasant opportunities to travel to enjoyable countries. If (i), to make high profits for their companies appears unimportant, managements will pursue (ii), (iii) and (iv) instead. They will make no effort to put pressure or worse still dismisss inefficient colleagues. There will be a live and let live atmosphere. Difficulties with the trade unions will be avoided. If they want promotion by seniority (time in the company, or age) instead of by ability as managements will concede it as in British Railways and London Transport. There will be few efforts to discipline or dismiss workers who clearly fail to do their jobs. Office conditions and work travel conditions will be more expensive than in the private sector: almost everyone who works for British Railways travels First Class.

With this X-Inefficiency (the gap between actual and potential productivity) public corporations have higher costs than private companies producing the same products. UK examples from Richard Pryke include cross-channel ferries and gas and electricity showrooms and travel agencies.

Nationalized industries destabilize economies by earning inadequate surpluses to finance social welfare. The result is that public finances and the balance of payments are vulnerable with the consequences we observe in many countries.

The root cause of the difficulty is the subordination of profitability to a variety of worthy and desirable social objectives. The consequence is that many nationalised companies become elements in a country's welfare state so that true welfare cannot be financed.

The advantages of privatization which avoids the destabilization risks which have been outlined include the universal achievement of higher productivity, and the removal of an obligation to finance the borrowing of the public corporations through sales of government bonds or money printing. The distinguished Keynesian economist, Roy Harrod noticed as early as 1958 (in *Policy Against Inflation*) that:

"so long as the problem of financing the nationalized industries is unsolved, there is a real danger that in another boom things might slip further, leading to the destruction of sterling, and of our world interests that depend on its maintenance".

If that describes the extent of the danger as seen by a distinguished Keynesian economist in the UK in the prosperous 1950s, it will be many times greater in countries like Russia or China or Italy where far more of the economy is state owned and controlled.

© Professor Walter Eltis

How Protection Destablizes

The countries which cut themselves off from world trade after 1945 have performed weakly in comparison with those which have sought to position themselves in international markets. Compare the East European, Latin American and most of the African economies and India and Pakistan with Europe, North America and the Pacific Rim. Compare East Germany with West Germany. Success in world markets has depended more than before 1939 on product quality and design, and competition has proved one of the two most significant elements in the establishment of high quality production.

Much theoretical economics has been presented with the assumption that economies produce a single good or else two goods (a consumer good and an investment good: or else a good which is imported and another which is exported), and these are of homogenous quality throughout the world. The investment good is often labelled steel and some of those with economics degrees may have inferred naively from this that a steel industry must form the foundation of a successful economy. Hence virtually every country has a domestic steel industry which it protects with the result that there is a huge world over-supply of steel. There are of course a near-infinity of capital goods, each has different functions, and producing with state of the art equipment is an absolute precondition for efficient production. A vast fraction of these specialised capital goods is imported, even in the world's most advanced economies because each leading economy is ahead of others in the manufacture of some kinds of equipment.

Economies that are less crudely managed and govern through development plans seek to target certain activities which they subsidise and protect with complex systems of domestic taxes and rebates. In a celebrated OECD study, Little, Skitovsky and Scott showed in the 1970s that the value-added of Pakistan's industry when all products were measured at world prices was negative. Pakistan had set up an interlocking system of taxes and subsidies which were leading Pakistani businesses to turn scarce and valuable raw materials into finished products which were worth less. Complex systems that sought to protect have often generated poverty, and especially in the world's poorest countries which became a hospitable test-bed for the ideas of two generations of economic development models.

Effective Protection and Negative Effective Protection

A first step towards the comprehension of the economic impact of protection is to understand the concept of 'effective protections'.

My first example will be a country which manufactures cars and freely buys components from overseas which amount to 60 per cent of the ex-factory world market price of a finished car of the quality it manufactures. In the absence of protection, it would buy components for 60, add value of 40 and sell the finished car for 100. If its government imposes a tariff of 40 per cent on finished cars, the country will be able to sell its finished cars in its home market for 140. Its value-added can therefore rise from

40 to 80 per car, i.e. it can get away with being half as efficient as before and still compete in the home market.

In this example the nominal rate of protection of finished cars is 40 per cent, but the rate of **effective protection** the car manufacturer enjoys is 100 per cent. The rate of effective protection is **nominal protection/value added in the absence of protection**. Because nominal protection is 40 per cent and value-added in a competitive market would be 40 per cent, the effective protection the manufacturer enjoys is 100 per cent. Where components can be bought freely and finished products are protected, rates of effective protection can greatly exceed nominal protection and featherbed vast inefficiency.

Consider now an example where manufacturers of car components are protected but not those who sell finished cars. If the components which would cost 60 in free markets actually cost a car manufacturer 80, because protection raised their price in the country in question by one-third, but the car manufacturer had to sell assembled cars for 100, his value-added could be marketed for no more than 20.

The protection of components would squeeze final product manufacturers. They have to pay more than international competitors for their inputs (as much as 80 instead of 60) but because they all sell at the same world prices (100) they would receive only half as much (20 instead of 40) for converting components into finished cars. Their income per car assembled would be twice as great if the country practised free trade. The car industry is actually subject to **negative effective protection**.

In terms of the above formula, the rate of effective protection is nominal protection/value-added in the absence of protection. Here nominal protection is -20 per cent of the finished car, while value-added in the absence of protection is 40 per cent. The rate of effective protection is therefore minus 20/40 or 50 per cent.

In the first example the car manufacturer's outputs were protected but not his inputs. In this example effective protection is higher than nominal protection. In the second example inputs are protected but not final outputs. In this case effective protection is less than nominal protection and it can even be negative as in the above example.

In general effective protection will exceed nominal protection if final outputs are protected more heavily than inputs, while effective protection will be less than nominal protection if inputs are more heavily protected than final outputs.

Consider the era of extensive nationalization of the commanding heights of power. British manufacturing industry had to buy steel from the nationalized steel company, coal from the nationalized coal industry and electricity from the nationalized electricity industry. These generally charged prices which reflected their inefficiency and British manufacturers had to buy from them. The private manufacturing sector had to sell its final products in world markets where internationally competitive prices involved little protection because of the European Community and the agreements arrived at through GATT and the Kennedy round. UK manufacturers were therefore squeezed between the inflation of input prices due to obligations to buy from the local nationalized companies, and near competitive final output prices. Much of British industry was therefore suffering from negative effective protection. Now we have carried privatizations further so we are benefiting from cheaper coal, steel and electricity than Germany.

But there is another source of negative effective protection in the European electronics industries. Europe is seeking to build up a strong domestic computer industry so it is protecting the manufacture of semi-conductors and the more sophisticated IT components. Hence anyone who seeks to move from semi-conductors to finished computers is suffering from negative effective protection. European semi-conductors cost 18 per cent more than Japanese or US semi conductors, so all those who use semi-conductors and suchlike in Europe are handicapped. This underlines how damaging it is if one protects components and inputs. The calculation of the rate of effective protection, a concept pioneered by Max Corden of the Australian National University, Canberra in the 1960s, is complex to estimate, but it nonetheless greatly assists clear thinking about protection.

The most damaging element in negative protection may be the European Union's establishment of the price of food at a level 60 to 80 per cent above world prices. This raises the cost of labour and squeezes profits, a theory established in 1817 by the great British economist David Ricardo, which led to the repeal of the corn laws and the establishment of British food as the cheapest in Europe. 50 Years earlier in 1767, the great French economist François Quesnay invented the world's first input-output table, much praised since by Nobel Prize winners. His *Tableau Économique*, which showed that each extra agricultural job established as a consequence of a higher price of food would lead to the creation of four extra industrial jobs, as wealthier French farmers spent and invested their extra money. The Énarques who govern France have absorbed that lesson, while we have absorbed Ricardo's lesson, but no-one now reads Quesnay and Ricardo. Ricardo made £800,000 in the City, bought the "rottenest of rotten boroughs" on the advice of the radical James Mill, and invested his city wealth in 14 manors, one of which Gatcombe Park is now the home of the Princess Royal. On 16 May 1822 he told the House of Commons with remarkable prescience that:

He conceived that were the corn laws once got rid of, and our general policy in these subjects thoroughly revised, this would be the cheapest country in the world; and that instead of complaining that capital was withdrawn from us, we should find that capital would come hither from all corners of the Civilised world ... England would be the cheapest country in which a man could live; and it would rise to a state of prosperity, in regard to population and riches, of which, perhaps, the imaginations of hon. gentlemen could at present form no idea. (Ricardo, *Works and Correspondence*, vol v, 187-6).

Quesnay, a Fellow of the Royal Society of London and the French Academy concluded his scientific career by publishing a solution to the mathematical problem of squaring the circle.

Protection that reduces imports damages exports

Every country's trade reaches equilibrium over decades, so if it adopts domestic policies which lead to lower imports, its exports will fall towards the same level. The mechanism is that when imports are reduced through tariffs and import quotas, a country's balance of payments current account is strengthened, and this will make its exchange rate higher than it otherwise would have been. That will reduce its exports by about as much as imports are reduced over the decades. Therefore a heavily protected economy will automatically develop a weak export sector. At the time Professor Corden first published, Australian manufacturing industry enjoyed about 80 per cent effective protection, and only 4 per cent of Australian manufactures were exported. Now Australians effective protection of manufactures has come down towards a European level.

The lack of quality control in protected markets

The most important anti-protection argument is the way in which this feather-beds inefficiency and especially X-inefficiency. I therefore conclude with a paradox. Japan, one of the world's two most efficient industrial economies, protects manufacturing industry heavily from imports. Foreign manufactured skis used not be allowed into Japan because the government decreed that Japanese snow was different. How does Japan achieve industrial efficiency from a productive base which is so heavily protected? I conclude with the hypothesis that they have quality control mechanisms which the UK and the former East Germany lacked. We and East Germany needed free trade to produce sufficient pressure on companies to be efficient. Japan was evidently efficient while explicit and implicit protection still remained substantial. Why that should be is evidently a key question with important implications for industrial policy.

© Professor Walter Eltis