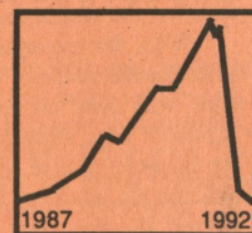


ECONOMIC INTELLIGENCE



C I T

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PM'S POLICY FOR RECOVERY FLAWED

AND SO the inquest is over, with John Major's Tory party safely back in power, and nothing learnt in all the hullabaloo at the hustings. Britain is in for another five years of Conservatism, with the immediate problem of having to pay back the large politically-inspired government debt while the economy is stagnant.

A dangerous consensus has built itself around the explanation for what caused the UK recession: deregulation of the financial system in the early 1980s. Curious, because identical problems with economies elsewhere in the world could not possibly have originated for the same reasons - for they did not deregulate their financial systems. Unless the UK is to avoid another treadmill business cycle, a clear understanding of what went wrong is a crucial prelude to articulating new policies.

So what did go wrong? Consider the stories that unfolded on either side of the border between England and Scotland.

Throughout the Thatcher years, actual pre-tax average incomes rose at a similar pace on both sides of the border. Yet the income required to maintain a fixed standard of living at local prices varied so significantly that, in North-West England, the growth of real purchasing power was half that of Scotland's (see graphs)* Why?

The difference was in the cost of housing. But that is not a correct classification of the source of the problem, for the costs of bricks-and-mortar and furnishings were similar on both sides of the border. The difference was a measure of what happened in the land market. South of the border, land prices boomed in the way that they did not in Scotland.

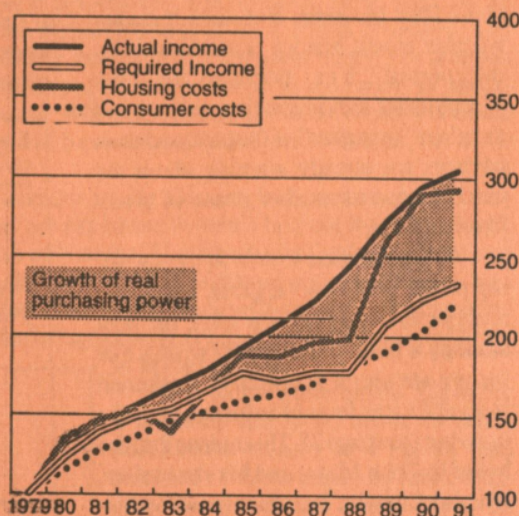
Result: English workers had to struggle harder to finance the needs of their families, after paying for shelter. As a result of the land boom, their purchasing power was reduced. Translate that into macro-economic terms, and we see why the spending power of English workers was savagely curtailed during the late 1980s. This had to express itself in a cutback in construction and a close-down of retailers.

The Scottish economy, by contrast, remained buoyant. Housing (=land) costs were contained within the limits of people's actual incomes, which meant that local businesses were not decimated. Not surprisingly, therefore, unemployment problems first emerged in the south-east, and like a cancer moved inexorably northwards.

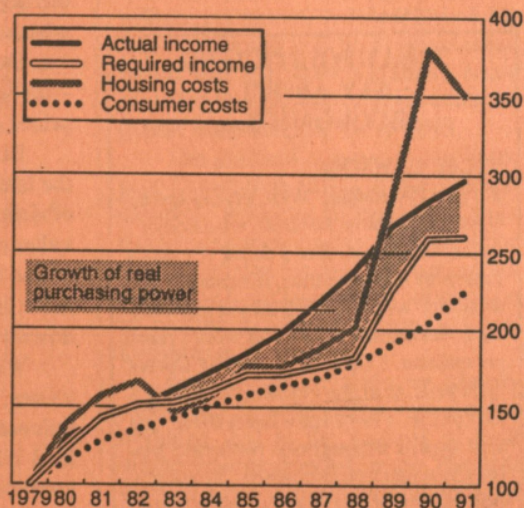
FACT: according to the latest survey by Manpower, the employment agency group, while employers in the North-West expect further cuts in jobs, Scotland remains buoyant: 23% of employers there expect to be taking on more staff while only 9% forecast cuts (see chart, page 2).

FACT: prudence in the Scottish property market during the 1980s is reflected in current rental trends. According to London surveyors Hillier Parker, rents for London office space have fallen by 26% over the past

Scotland



North West



year; in Scotland, they increased by almost 4%.

How does this story fit with the new wisdom? It does not. For example, the boom of '88/90 is characterised as "The Lawson Bulge" - Nigel Lawson, the former chancellor of the exchequer, is going down in history as the culprit who introduced

*"Required income," as measured by The Reward Group, includes consumer goods, fuel, transport and housing. It is based on 31 national prices and 18 regional prices.

a too-generous budget in 1988. He did make mistakes, but these were trivial in terms of the underlying tendencies.

Why, for example, when Lawson acted for the whole of the United Kingdom, was there no similar "bulge" in Scotland? Why, since the deregulation of the financial system in the early 1980s affected the whole of Britain, were the alleged ill-effects not generalised: the boom in asset values in England was not matched by a comparable effect in Scotland.

The explanation for the recession, then, has to be sought in the propensity to push up land prices, such that crippling obstacles are placed in the way of entrepreneurs and workers who want to go about their business. But does it matter whether recent history is now correctly interpreted? Yes, because the new Westminster administration will try and avoid the "mistakes" of the past, and their advisers are already warning about the need to prevent another phase of credit liberalisation.

The temptation to rein in the spending power will now be great. But if the analysis is wrong (which it is), the new strategy is likely to be equally wrong. For the private sector is critically weakened in its ability to finance investment in the upswing (see page 2). This means that the belief by John Major and his chancellor, Norman Lamont, that new growth opportunities will have to be underwritten by the private sector, will prove tragically wrong.

WHAT POLITICIANS SAY ABOUT ECONOMICS....

NIGEL LAWSON

Ex-Tory Chancellor. "Well, errors are always made, there's nobody who doesn't make mistakes... But I think it's an illusion to suppose that, if mistakes are avoided - we're talking about mistakes by government now - you won't have recessions. I believe and have always believed... that the economic cycle is a fact of life. There have been these ups and downs throughout recorded history, not just in this country. Throughout the world, there always have been, there always will be."

DENIS HEALEY

Ex-Labour Chancellor. "The older I get the more convinced I am that most of the theories on which economics is based are bunkum."

GEO-POLITICS (1): THE CORPORATE CRISIS

WHO WILL PAY for the recovery? G7 governments are helping the ex-Soviet economies to finance their restructuring, but precious little attention is being devoted to the same problem in the market economies.

Reason: western governments presume that the financial system will perform its traditional duty of supplying the liquid with which to fund the capital investments that are the crucial prelude to full employment. Mistake. It won't happen this time, and as a result the upswing will be seriously undermined.



The world's financial system is in the depths of a crisis, the full extent of which cannot yet be gauged. It all depends - as they are now discovering in Tokyo - on when the taboggan slide in land prices comes to an end. Why?

Because the bulk of bank loans during the late 1980s was advanced on the back of rising land prices. Huge chunks of the value of that collateral have now been wiped out. But the worst is not yet over: there is still a long way to go in the downward adjustment of valuations.

With every percentage decline in land values, the major banks become more vulnerable to bankruptcy and less able to lend when the time comes for the corporations to invest their way out of the trough. Central bankers therefore want to establish an early warning system, to head-off a crisis in one country which could trigger a global domino-effect.

◆ In Britain, according to a new report by brokers County NatWest, the high street banks are under-provisioned

by up to £4 billion to set against shaky loans to property companies. So serious is the situation, argue the brokers, that the Bank of England will have to intervene.

The exposure of British banks to the property sector is estimated at about £17 billion, and County NatWest compares the crisis to the third world debt debacle. When the exposure of foreign banks is added in, the financial sector is exposed to British property companies to the tune of £40 billion.

SO NOW WE KNOW what is behind the so-called credit crunch: the downward trend in land prices. But where does that leave the entrepreneurs? They will need to finance the upswing. Their ability to do so will in part depend on the corporate policy on dividends (plotted by *The Economist* - see the inset graph). There is a marked difference between the UK and USA, on the one hand, and the two pace-setting giants (Japan and Germany) on the other hand.

British companies are particularly generous in their dividend pay-outs. Result: their relative capacity to undertake capital investments out of internally generated cash is seriously diminished. In January, Tiny Rowlands paid the price for bucking the traditional trend. He strengthened Lonrho's coffers by cutting 3p off the payout on each share, and investors punished him by wiping a large slice off the Lonrho share prices - and reducing the value of Rowlands' stake by nearly £40m.

Strategically, Rowlands was right. For British corporations that continue to rely on the banks for money, come the upswing, will find themselves at a serious competitive disadvantage. European interest rates are high, and - thanks to the Exchange Rate Mechanism - will continue to retard the prospects of investment in capital goods and new products for most EC countries. Relatively speaking, that will not hurt Germany companies. Although Germany has pushed up her interest rates to levels last seen in the 1930s, her corporations retain an edge because, historically, dividend pay-out to shareholders has been at the low end of the scale.