

Essential, Authoritative Analysis and Opinion for Board Directors, Senior Executives, Investment Professionals and Advisers

CBI guidelines on severance packages What they really think What the government should do

"Business can only benefit from increased shareholder involvement... Perhaps now is also the time to see greater transparency in the way that fund managers are rewarded and how investment decisions are taken."

Digby Jones, CBI Director-General

"This research helps to clarify the range of governance and SRI issues on which the UK's investment institutions share a common position."

*Colin Melvin, Director of Corporate Governance, Hermes Investment Management**

So the answer to what the government should do for the economy (and almost everything else) is simple. Shrink - shrink a lot and shrink fast. As Jefferson said, government governs best that governs least".

Terry Arthur

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The Economy: What the government should do - and why it won't

Terry Arthur puts forward a policy for avoiding or minimising boom and bust cycles but goes on to argue that something more than just recommending correct policy is needed to make a real difference.

Hitherto, the articles in my "Governance of Government" series have largely stuck to my original brief which is to point out failures in the governance of the (UK) government. To date I have exposed several failures relative to accepted (and nowadays usually imposed) standards in the private sector. Examples covered include the Blair government's first and only 'annual' report (1999-2000), government's pensions mis-selling, and last May's attack on the unholy alliance between government and John Maynard Keynes, with particular regard to the overwhelming role of the manipulation of money and interest rates in causing the boom and bust cycle.

The Executive Editor expressed great interest in the last article but wondered whether I had an article 'up my sleeve' explaining what the government should do. Using my own paraphrasing, "it's all very well to keep attacking what they're doing, but can't you be constructive for a change?" I hope that Part 1 of this article suggests that the answer may be yes, in the sense that I can articulate a better policy for avoiding or minimising boom and bust cycles. (A short recap on Keynesian policy comes first.) However, as Part 1 also illustrates, I believe that there isn't a cat in hell's chance of such a better policy being pursued in the near future. Something more than recommending correct policy is needed; alternative means (including government-bashing) are legitimate and indeed constructive. Accordingly, Part 2 of this article defends such a practice.

PART 1: KEYNESIAN BOOM AND BUST

In my last article I showed that attempts to 'stimulate' an economy by artificial credit expansion (using monetary expansion and low interest rates) result in a false boom which must bust. Such a policy not only devours more consumer goods; it also ensures that industry shifts towards long-term projects that take too long to get the goods on the shelves. This is a double whammy from both ends of the chain of production.

The essential Keynesian errors here are (i) the belief that market interest rates are the result of trading off liquid cash versus longer term bonds (i.e. two forms of saving) without any influence from saving versus consumption; (ii) the false refutation (via misrepresentation) of Say's Law that markets

keep supply and demand in balance in aggregate; (iii) the idea that growth comes from consumption as opposed to saving; and (iv) that 'animal spirits' provoke markets into gigantic fits of euphoria and despair.

To believe Keynesian business cycle theory one has to do the splits and seal the theory off from general price theory. Yet this untenable position is a primary 'justification' for Central Banking, thus replacing markets by command-and-control in the areas of money supply and interest rates.

Free market money and banking

In other words, Central Banks and their manipulation of money cause booms and busts. The cure is not hard to see - abolish Central Banks - the real 'animals'. In the UK this means abolishing the Bank of England, abolishing legal tender laws, and allowing competitive money to arise.

How would money and banking work without a Central Bank? For day-to-day users, certainly those who have ever held a Scottish banknote, the broad answer is probably "just like it does now" (and subject to one possible difference, "just as it did before the advent of Central Banks and nationalised currencies"). Banks would be free to issue their own notes, which would be exchangeable at par, and currency and credit transactions would carry on as normal.

Banks would also hold reserves of redemption money; competition would ensure that they wouldn't get away with the Bank of England's circular trick of inscribing on a pound note "I promise to pay the bearer on demand the sum of one pound"! Redemption money is non-bank money, used for withdrawals. Historically, the redemption money selected by the market was gold but that may not be so this time round - perhaps RPI-related vouchers for goods and services would be a contender.

The most recent UK experience of free banking was in Scotland, which was a great success until it was ended in 1845 by an extension of England's Banking Act which restricted the note issues of the Bank of England's competitors. (The Bank of England was formed in 1694 to finance government debt. It was granted immediate legal privileges, granted a monopoly of note issue in 1844 and totally nationalised in 1946.) Swedish banking was also free

between 1831 and 1902 and there are many other examples. Unfortunately, free market money was first hijacked and then nationalised, followed by retrospective removal of the promised redemption in gold.

Under free banking, naturally emergent clearance systems ensure that banks (either singly or in concert) cannot over-issue notes relative to their reserves. This removes one of the major abuses of nationalised money and Central Banking via which, in the words of FA Hayek, governments "have incessantly and everywhere abused their trust to defraud the people".

The other main advantages of freedom in money and banking lie in the resulting stability - with regard not only to avoiding boom and bust but also to price inflation. The key is the rapid signals provided by debits and credits of reserves in the clearing system. A Central Bank has no such information and it cannot distinguish between demands for money-to-hold and money-to-spend (which require different policy responses). Furthermore, its Lender of Last Resort function hobbles its freedom to contract in size, forcing reliance on interest rate manipulation which is at the heart of booms and busts. It is a supreme irony that the main reason advanced for Central Banking was the supposed need for a Lender of Last Resort to avoid contagious bank runs - a 'need' which arose directly from the statutory restriction of private banks' note issue.

Back to the unholy alliance

The benefits of free market money and banking, both theoretical and historical, are plain for all those who seek to look. (A short reading list is included in the shaded box.)

Unfortunately, none of this will happen in the near-term future. Some of the reasons were explored in my previous article. Basically, governments like Keynesianism and Keynesians like government. Keynes' own position is perfectly clear from his preface to the 1936 German edition of his magnum opus *The General Theory of Employment, Interest and Money* which included the following genuflection to Nazism.

"The theory of output as a whole, which is what this book purports to provide, is much more easily adapted to the conditions of a totalitarian state, than is a theory of the production and distribution of a given output, produced under condition of free competition and a large measure of *laissez-faire*". Precisely!

The common threads in Keynesian theories are that something can be had for nothing and that big government can provide it. Hence, the multiplier theory (as an excuse for favouring consumer spending), the supposed scourges of market-led deflation and liquidity traps, the idea of the reducing marginal efficiency of capital, and the IS-LM model, which are all found seriously wanting under the microscope of genuine economics (see reading list). He was strongly

opposed at the time by some leading economists of the day (including Friedrich A Hayek), and since the 1960s at least, the number of serious Keynesian adherents has dwindled. Keynesianism, still flourishing in political circles, is becoming defunct in academia.

So the answer to what the government should do for the economy (and almost everything else) is simple. Shrink - shrink a lot and shrink fast. As Jefferson said, government governs best that governs least. But since not even supposedly altruistic monks would voluntarily dissolve their monasteries, we now have the nub of the problem.

PART 2: CONTAINING GOVERNMENT

Small is beautiful

A century ago, government in the UK was small, with taxes and government spending at little more than five per cent of output. Now it is 50 per cent. Furthermore, state regulation of private activity has surged - to the point where many activities are either banned or compulsory! This means state-imposed costs of perhaps another 15 per cent. This level of government is already close to being without precedent in civilised society - yet the pace of expansion is quickening. Living standards, including qualitative aspects, cannot fail to fall unless this process is swiftly and strongly reversed.

Why? Essentially there are four reasons:

First, Command and Control cannot work; commanders don't have enough information and what they have is out of date. The major problem for any economy is how people's actions are efficiently co-ordinated. Adam Smith's 'Invisible Hand', essentially market prices, is the only workable co-ordinator.

Secondly, Public Choice Theory (i.e. the economics of politics) demonstrates the inferiority of political decision-making to that of markets. Democracy does not help; voting cannot reflect desires in any meaningful way and is uninformed (because it does not pay to become informed when the stake in the outcome is tiny). In addition, political action is itself subject to vested interests on a massive scale - one of which is of course to expand the empire.

Thirdly, liberty is largely indivisible; one cannot separate 'civil' liberty from 'economic' liberty. Freedom of speech, freedom of assembly, freedom to trade, and private property rights come (or don't) as an integrated package.

Fourthly, power corrupts. The present government already resembles George Orwell's (actually Eric Blair's!) pigs, and the bureaucrats the dogs, in *Animal Farm*.

There may be some isolated instances where an angelic government with extensive knowledge could make a marginal improvement in the human condition, but actual government is neither angelic nor able to see in advance what those isolated instances are. Faultlessly picking winners is not an option any more than is 'correcting market failures'; what is on offer is interest groups, tainted

government, the law of unintended consequences and the suppression of price signals. The first law of economics is supply and demand; the first law of politics is to ignore the first law of economics.

As Hayek argued, unlimited democracy contains the seeds of its own destruction. Everybody tries to rob everybody else using government as a (highly expensive) middleman until the system is no longer workable. Or as a young Italian immigrant in the US wrote to his parents back home, suffering at the hands of Mussolini, "What makes America great is not the right to vote; it is the right to be protected from those for whom you do vote!"

Where do we go from here?

So, what does one do? There are several useful roles but behaving as another vested interest, seeking something from the trough, is not one of them. Lobbying for funds and favours grows in line with the size and power of government in a self-reinforcing mechanism.

Little better is arguing for government funds for a more lofty purpose, totally divorced from one's own grubby paws. There are many impostors in this process of course but even without that the activity is questionable - although perhaps less so if the argument put forward includes specific proposals for making an equivalent, indeed larger, reduction in other government spending so as not to increase the total. Even then the 'he who pays the piper' syndrome means that independence is lost - one has only to look at the major charities, several of which are becoming little more

than deliverers of state welfare, to see that.

Much more rewarding and effective, to my mind, is to promote ways in which government can be made smaller, seeking private funding for the purpose.

Discredit where discredit is due

Finally, satirising and lampooning, staunchly criticising, snapping at the heels of government, etc, are entirely valid, indeed necessary activities. As my November 2002 article "None of the above" pointed out, Mark Twain's view was that irreverence towards government is the champion of liberty and its only sure defence.

For government to be cut down to size, someone needs to give discredit where discredit is due, and this is my role for this journal - to criticise the governance of government.

There is no shortage of material - the supply of appalling government behaviour is also expanding, alongside the size and power of government, as one would expect. I do not need to stoop to exaggeration or unfair tactics to find suitable examples. While this remains the case, I hope to carry on pointing out the chutzpah in the pigs!

As stated in the May article, the economics of Keynes will be explored further in due course in an article for Economic Affairs.

Terry Arthur is an actuary holding several non-executive positions including a directorship of Royal Mail Pension Trustees Ltd. He writes regularly for Governance in a personal capacity.

READING LIST

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Keynesian Demand Management, Consumption, Saving, Multiplier

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Jacek Rostowski (2003), *The myths of a deflationary spiral*; *The Financial Times*, 3 June 2003.

For Japan's 12-year recession and its causes, see especially the writings of Frank Shostak and Benjamin Powell available from Ludwig von Mises Institute, and Sean Corrigan in the UK on www.capital-insight.com