LINCOLN BUSINESS SCHOOL

UNIVERSITY OF LINCOLN

Business Studies Update 2010/11

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The University of Lincoln does not necessarily agree with views expressed in this *Update*.

HOW TO USE THIS UPDATE

University of Lincoln Business Studies Update 2010, which covers a period from September 2009 to around July 2010, is compiled to provide case studies and information on topical issues in the business environment for Business Studies and Economics students. It is prepared in conjunction with a new journal, *Financial Update 2010*.

It is hoped the students will find it helpful for EXAM and COURSEWORK preparation as well as challenging conventional wisdom. It is common practice to reward a script that is well written, with topical examples, placed in an appropriate context. We trust *University of Lincoln Business Studies Update 2010* will prove useful for Business Studies and Economics students.

Read the Financial Times

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The Business Environment

As a social science, Economics has the advantage over many other subjects studied to ‘A’ level and beyond in that is seeks to provide a framework from which models of behaviour can be drawn and policy prescriptions can be advocated. This is complicated, however, by its very nature. As a complex world is too difficult to model, Economists use the vehicle of simplifying assumptions, stripping out what some might regard as insignificant variation in the drive towards a comprehensive model of an economy. This stripping out is not uncontested terrain. Different schools of thought give conflicting guidance as what is important and what is not. In theory of the firm, the motivation to maximise profit is important so that output can be predicted under various forms of market structure and a policy concerning competition can be constructed on its predictions. However, the very goal may not be one targeted by firms.

Not all of the simplifying assumptions are anywhere near realistic or helpful. In a world of perfect knowledge, behaviour is perfectly predictable, suggesting there is no role for the unknown. As is very obvious, there cannot be perfect knowledge only imperfect or partially-perfect information. Indeed, entrepreneurs make a living out of making good judgement about future behaviour could:

- construct products that customers are likely to want, e.g. Apple iPads;
- provide additional information that is only partially perfect, so that consumers are less likely to make an adverse selection, e.g. comparison websites or estate agents;
- where consumers are not willing to, shoulder the risk of adverse changes in the economic environment, so that a market failure is less likely, e.g. insurance or derivatives;
- exhibit behaviour that would breed trust and reliability among consumers, so that a market failure is less likely, e.g. building up a good reputation.

When it comes to the unexpected, in a macro sense, Economics can be unusually restrictive. The notion of rational expectations presumes that there is a universal model in people’s heads. An unexpected shock will cause a deviation from the commonly recognised equilibrium. There will be some knowledge gathering whilst economic agents seek to make sense of the new world. Once they are ‘fully’ informed, equilibrium will be re-established. Disequilibrium is only ever temporary during the information accumulation stage.

It is not clear that the entrepreneur or the state collectively should shoulder all risk. The consumer must bear some. Every day we run the risk of unexpected events occurring that may or may not be our fault. Adults are expected to 'act rationally', making good judgments about themselves and their environs - AKA taking appropriate risks. Increasingly, perhaps rightly, consumers are demanding more information so that they can make better judgements and are more outraged by the withholding of it. Government, though, appears to be increasingly regulating behaviour, such as eating habits, in a more invasive way, suggesting it believes that adults are not taking appropriate risks. The redefinition of what government should be doing will be a feature of the next few years.

Reputational Issues

As is becoming a perennial feature, in *Update 09* an opening point was, due in part to endemic uncertainties and informational asymmetries, business operates in a world of imperfect information. Reputation relates to one [or more] parties making judgements about another group's likely future behaviour. Given that judgements about another group are made on the basis of imperfect knowledge, there is likely to be a learning process by which judgements will be formed by making the best use of the information to hand at each point in time.

Although we would like to believe that virtue brings its own reward, the Economist takes a monetised and instrumental view. Using marginal analysis, and presuming that maintaining a 'good' reputation 'costs', a business can select a degree of reliability. A profit maximising firm decides to adopt a strategy of targeting a reputation for a certain level of opportunism, corresponding to a point where the marginal costs of maintaining a reputation equal the marginal benefits.

Take the case of Marks and Spencer, which, in July, decided to close four 'failing' stores in Grantham, Skegness, Nuneaton and Scunthorpe. Its reputation for providing a good service is not undermined by the claim that each of these stores is not longer commercially viable. People trust M&S to make such decisions that occur normally in a retailer's world. However, in this and the accompanying journal, *Financial Update*, it will be shown that not everyone is willing to accept that individuals or institutions can be granted that latitude or deserve that level of trust. During the period covered, some failed to cover themselves in glory, seeking to take the easier, more opaque route to disclosure over their behaviour. Not only was there a Greek sovereign debt concern, despite government support, many banks behaved

in a less than desirable way, and certain companies seemed more concerned about the financial rather than the reputational or social side of a tragedy.

Trust in the Government

The Government/ Bank of England's (BofE) track record of forecasts of future growth is less than ideal. Too often were the forecasts on the sunny side of the street. Investors became cynical, believing government intervention in the reporting of these forecasts to provide a more favourable picture. In an Indicative Planning sense, there is a logic to this. If workers believed the cost of living would be lower than otherwise, their wage bids might reflect that, putting less pressure on costs, so fulfilling the prophesy of lower costs of living. Like the problems that befell the medium term financial strategy in the 1980s, credibility is everything. Workers will not 'believe' without a track record of success. To reassure money markets, the Coalition Government of Conservatives and Liberals, formed the Office for Budgetary Responsibility, charged with providing forecasts beyond government interference. Showing its teeth, it immediately presented an estimate of the output gap of 4% of GDP when the Treasury estimated 6%. However, not long after, Alan Budd, the face of the OBR, announced he was leaving. Next, some figures that were leaked before they were presented formally, were not identical. The estimated job loss in the public sector by 2014-2015, as a result of budgetary changes, was leaked at 775,000 but was 175,000 lower when made official. It appeared that the very basis for the OBR was compromised from the outset: the government had fiddled the estimates for public consumption.

Can You Recall the Mistakes You've Made?

The assumption of perfect information is commonly not fulfilled, so poor behaviour may not be so widely known. The rogue relies on this. However, modern media, through the sheer speed of the information exchange, can move us closer to a better-informed world. There are some recent examples of the benefits of this modern phenomenon. The Guardian and Private Eye sought to defy a court injunction placed on them so that a parliamentary answer to a question could be reported. Seeking to hide the Minton Report into an allegation of dumping of toxic waste off the Ivory Coast by Trafigure, an injunction from the High Court was secured by their lawyers, Carter-Ruck. As Twitter disseminated the bones of the story too quickly, Carter-Ruck chose not to enforce their gagging order. As it turned out, the Guardian and Private Eye were right to make this activity public and it is a triumph of modern technology that more rapid information dissemination made, what turned out to be, a cynical ploy inert. In July, a Dutch court fined Trafigure €1bn. Thus, in our age, poor behaviour is not so easy to shield from the public eye.

Maclaren

Another Twitter success concerned Maclaren and its child's buggy. In early November, Maclaren, a child's pram/buggy maker, announced, in the US, a recall of models that had, over a 10-year period, through a design flaw, amputated the fingertips of 12 children. Of course products are not always perfect when they hit the streets. Car companies announce periodically recalls for corrective measures to be undertaken for safety reasons. Maclaren faced over 1m items having to be replaced.

Sometimes companies attempt to ride out a problem and hope that the complaints are not significant. Perhaps using marginal analysis, where the cost of correcting the problem is greater than the injury cost, comes into play. In *Update 08*, Cadbury was featured. It was forced to recall over a million bars of chocolate after some were found to be infected with dangerous levels of salmonella and 30 people contracted the infection. The classic case of corporate cynicism is repeated in textbooks as the Ford Pinto case. A design fault in the 1971 Ford Pinto was estimated by Ford executives to cause 180 deaths. The costs of these deaths to Ford would, they calculated, be less that the cost of redesigning the car. Marginal analysis suggested the company rode their luck. In sense, they were vindicated in that only 27 were killed. But Ford's reputation as a builder of safe cars (or mobile petrol bombs) was tarnished.

Maclaren appears to have fallen into the same trap, but in a different era. Today, as the Trafigure case illustrates, information about poor behaviour is more widely and more rapidly disseminated and the legal costs can be much higher. Maclaren either looked solely at the private costs and benefits or ignored the social/reputational issues as they *did not* recall the buggies worldwide, but in the US only. On the day of recall, Charlotte Addison, a representative of Maclaren, is reported to have stated that the company did not plan to recall the buggies in the UK and elsewhere, but was prepared to offer parents a free safety kit. Clearly offering different levels of protection, it appears that the more litigious environment in the US led to the differential response. That is, the problem would cost more to address in the US if the buggies were not recalled compared with elsewhere. Then, the Twitterers took over. Within two days, Twittering had led to complaints across the globe and Maclaren backtracking on its geographical discriminatory policy. At the resolution of the case in May, Maclaren offered compensation of between £2,500 and £10,000 to around 50 parents of UK victims.

Johnson&Johnson were subject to a criminal investigation by US regulators because it attempted to recall 68m bottles of a hazardous cough medicine made in Puerto Rico and 136m made in Fort Washington on the sly. There were 770 reports of side-effects in children. In 2009, the company sought to recall the medicines on the quiet by buying the bottles back without making an announcement. A J&J internal memo of 12 6 09 states that *there should be no mention of this being a recall of the product!* At a Congressional hearing it was stated that a formal recall did take place a month later and that the phantom one revolved around a Puerto Rican petrol station. However, the FDA did not know of the problems before the phantom recall, which suggests a conspiracy to deceive.

Nestlé was forced to source its palm oil from sustainable sources by also adopting a heavy-handed approach to negative publicity. A Greenpeace advert, asking consumers to help prevent deforestation, featured a Kit Kat. Nestlé complained to YouTube that this infringed copyright, but this only served to raise the profile of the advert on YouTube, boxing Nestlé in.

BP

The Deepwater Horizon explosion in the Gulf of Mexico occurred on 20th April. Tony Hayward's resignation as CEO of BP was announced in 26th July. Concurrently, BP announced the largest quarterly loss in British corporate history, $32.2bn. The resignation, which occurred after the latest well-cap appeared to be working, may have concentrated some of BP's reputational damage into the CEO. He was to stay on until the well-cap was secure, taking a significant proportion of the 'hit' giving BP more scope to rebuild their reputation.

BP, the oil company that changed is logo to appear more socially and environmentally aware, showed how CSR rhetoric and practice can be at different ends of the spectrum. Self-regulation with a profit motive and layer upon layer of contracting and outsourcing had, at least it was thought, put the oil platform explosion and then the leak beyond their fault. As with the financial crisis, BP should have prepared for a catastrophe. It appeared that, rather than operating under the guidance of safety regulators, there was an unhealthy association between them. As with the money-men, perhaps the only way to prevent injudicious behaviour in pursuit of profit is to give the mangers a moral compass also. The chairman, Carl Henric Svanberg admitted that BP focused on the financial rather than the environmental containment issue initially. What is clear from this is that when outsourcing, you run the risk of outsourcing your reputation. You can outsource a problem but you retain the accountability with your customers. It is likely that BP's reputation is worth more to BP than it is to BP's supplier. Attempting to shift the

onus of responsibility on to a supplier is unsound. Using marginal analysis, supplier may make the judgment that additional safety costs are not economically viable.

The disaster affected sales at BP petrol stations. Such was the concern that BP's 11,300 American stations owners were pressing for a rebadging of their units as American Amoco.

Using sophisticated marketing techniques and tapping into leading lights of the bloggessphere, Proctor and Gamble were slow to respond to a criticism of their new nappy causing rashes appearing on Facebook. Rather than listening, P&G's robust defence on 6th May, however, raised ire among loyal customers. The defence mounted by P&G implied that mothers were diagnosing the source of the problems based on hearsay through social networks. The bloggers, by the end of May had an entrenched view about the source of the problem, forcing the manufacturer to learn from the episode the need to intervene with a more engaging attitude. Social networks, for good or ill, have shifted the allegiances of customers, allowing them to share problems about the product in a way not available before, causing multinationals a major headache in managing product image, whether it is deserved or not.

Toyota

Car companies recall cars because of faulty parts; 7.1m cars were recalled in the UK in the nine years to 2009. Part of this is related to efficiency and cost cutting. To achieve economies of scale, standard parts are used across many models and even manufacturers, so if a part is found to be faulty, it could affect many thousands of cars. This is compounded by the drive for cost shaving, making the components with slightly cheaper metal or a bit quicker, perhaps making them slightly less robust.

The highest profile recaller this or possibly any year was Toyota. Over three months, from November it recalled 8.1m vehicles with brake or accelerator problems, of which 6.1m were in the US. In January, it halted production of six models, including the Corolla as a result of a condensation-related fault. The suspension of sales would cost the 1,200 dealerships dear. One dealership estimated that Toyota in the US would face $2.5bn/month in lost revenue. UBS estimated lost revenues of ¥14bn/week with an additional ¥81bn ($897m) in recall costs.

The latest version of the flagship Prius was recalled in February due to loss of braking power. Again, the brake problem affected many models, leading to recalling 436,000 hybrid vehicles worldwide. Concurrently, a US Congressional Committee questioned whether Toyota or federal safety officials had identified all the Toyota's

faults, pointing out that the redesigned floor mats failed to prevent the sticking pedals. Next, 8,000 Tacomas pick-ups were recalled in the US because of drive shaft problems.

Then the class actions in the US emerged: possibly 44 such actions were filed by February. Tim Howard of Northeastern University estimated that the claims could be worth $3.6bn @ $600/vehicle. Worse, a former Toyota lawyer, Dimitrios Biller, who was suing Toyota for wrongful employment termination, alleged that Toyota engaged in a conspiracy to prevent evidence of the structural shortcomings of its vehicles coming to light. A US Congressional Panel subpoenaed these documents in preparation for an interrogation of Mr Toyoda, the CEO of Toyota. It was conceded by Akio Toyoda, that, in attempting to become the largest car producer, his company had lost its way.

By March, it came clear that the lean production model, personified by Toyota, was not practiced. It emerged that 39.4% of its employees were temporary. Problems that emerged in 2006 on its Hilux Surf model did provoke a reaction according to Tadao Wakatsuki. Indeed, the rate of recalls over the 2000-2005 were 45 time higher than in earlier periods, with Toyota accounting for 36% of all industry recalls in 2005.

Honda managed to recall 646,000 Jazz in a week of Toyoda's multiple announcements. Their window switches smoked. This did not raise much comment. The following week, 378,000 US /437,763 vehicles worldwide were recalled because of an airbag that could over-inflate. The press release suggested the measure was taken reflecting the heightened sensitivity to car quality issues. Honda, in March, recalled 453,000 US-built vehicles because of brake problems

GM recalled 1.3m small Chevrolet and Pontiac vehicles in North America in March due to power steering problems. GM VP, Bob Lutz, blamed a supplier, JTEKT, a joint venture between Koyo Seiko and Toyota Machine Works, which has 5 plants in the US. The accusation was that the supplier had not met all the requirements of durability and reliability.

In April, Toyota recalled 870,000 more vehicles in North America, based on the concern that the spare tyre could fall off. As it was found to have a tendency to roll-over, the Lexus GX 460 sports-utility vehicle was awarded a 'don't buy' recommendation by Consumer Reports magazine. It suspended US sales. To cap this, Toyota was fined $16.4m for delays in notifying the regulator about flaws in the accelerator pedals. There were 200 lawsuits tied to accelerator accidents in the pipeline. The Toyota accelerator problem may have been known about in 2002.

In July, Toyota warned customers about potential faults with the engines of about 270,000 cars it has sold worldwide, including the Lexus. Toyota later announced the recall of 430,000 of mostly Avalon models made between 2000 and 2004 because of a steering system problem that could potentially lead to a crash if the steering wheel locked: that made it 14 recalls in 2010.

Toyota conceded that its desire to be the largest producer in the world meant that they were not sufficiently focused on the quality that gave then the reputation for excellence upon which it traded. A concern is that the Ford Pinto problem is not uncommon. Less than perfect cars, by build-quality or design, leave the factory every day. For them, the car companies appear to make the same judgement as Ford: addressing the problem may cost more than addressing the complaints. As the complainants are more costly to deal with in the US, recalls are swifter and on a larger scale there. Maclaren were just too obvious about that, but Toyota was fined for the same concealment.

Food Security?

Perhaps as a means of dispelling doubt over how food products come to market, Asda has started putting webcams in its food factories. Andy Bond, the chief executive, is willing to put them inside battery chicken sheds, clothing factories in Bangladesh or even an abattoir if customers so demand it.

Happiness

The French government appeared, in September, to be leading the way in incorporating unfashionable but logical economic policy ideas into their armoury. The Tobin tax was one such, another focussed on the notion of GDP and well-being. GDP attempts to measure work-done. As a proxy it measures what is exchanged and makes a guestimate about some of the rest, although, like accounting, the outcome is influenced by the conventions applied. Stiglitz and his International Commission on the Measurement of Economic Performance and Social Progress considered how to assess well-being and the use of GDP as a proxy for this. At a basic level, GDP measures output – what is produced. For this to be a measure of well-being, income would have to be closely associated with utility – the homo economicus' acquisitiveness predominates. However, in this era of greater social and environmental concerns, is more consumption enhancing utility? The human costs of production are not measured. Working longer hours may boost income but it comes at the cost of leisure, perhaps more stress and a less fulfilling family life. Investment requires a temporal shift of resources: less consumption now for more in

the future. Excessive consumption in one era could compromise the productive capacity in a later one. Depreciation of productive capacity is accounted for with or net national product (NNP) but does that include a degradation of the environment? GDP/capita is an average and may not reflect the well-being of the median income group or those at the bottom of the income hierarchy.

The Commission proposed adjustments to the way GDP is calculated; new measures of wellbeing and happiness; and new metrics for environmental and financial sustainability. By taking into account its high-quality health service, expensive welfare system and long holidays, one consequence of these changes, is to improve France's measured economic performance.

Stiglitz concern is that the measure breeds targets and claimed success may be misleading. Moreover, there may be a confusion of ends with means. If it is not funding something socially useful, having a sizable a financial sector is not an end in itself. It is odd to think that a private rent stream from a house contributes towards GDP but home ownership, without imputing a value for it, will not. However, among politicians, it is felt that home ownership is preferable, hence should enhance well-being more than renting.

Output Gap

As discussed in *Update 09*, assuming that the economy operates at a sustainable level, the output gap represents lost production. Sustainability in this context is zero inflation. Assuming the demand for labour is independent of supply, we could look to the labour market and, in particular, unemployment to assess the size of the excess capacity.

The governor of the BofE, in September 2009, was referring to the output gap. The output gap is difficult to assess if both long run (equilibrium) output and actual output are varying. In a period of post 1992 record unemployment, if capacity is being scrapped faster than unemployment grows, the output gap could be closing. Based on the actual numbers of workless, a stimulus would be appropriate. However, if the output gap is closing, this could precipitate inflation. Policy, then, would be to increase interest rates. The parallels with stagflation are obvious.

Underemployed

Despite the farsightedness, evidence is beginning to emerge about the downside to the schemes to preserve jobs. In Tam, H. (2010) Characteristics of the Under

Employed and the Over Employed in the UK, *Economic and Labour Market Review* Vol. 4.7 p8-20 it is reported that of the 28.745m in employment in Q1 2010, 3.47m wanted more hours of work and 9.825m wanted fewer. Of those that wanted fewer 2.624m would work with less pay in their current job. Earning less could improve well-being? Not normally what we would propose.

It was suggested in *Update 09* that more progressive responses to the downturn in demand had preserved many jobs. This would entail less than full time employment as a solution - causing underemployment. KPMG estimated that is saved possibly 100 jobs (£4m) by having ¼ of their 100,000 staff on sabbatical or working 4-day weeks.

The pay restraint of the 2008/9 period may have preserved jobs for many, but the big loser is the Treasury. It was estimated in December that 1.7m people took a pay cut or worked shorter hours. A third of all companies, covering 10m employees, agreed a pay increase of 1% or less. The tax-take in Q2 2009 fell by £17bn (16%) compared with Q2 2007 but then it preserved the numbers in employment and off benefits. A report in November, by R3, the insolvency professional body, found that in the recession, 7% of staff took a pay cut; 14%, accepted no increase in pay or took unpaid leave; and 30% worked longer hours or worked overtime for no pay. Indeed, the report implies over half of employees sacrificed hours of leisure to support their company in a manner inconsistent with neo-classical labour market theory. Monster.co.uk surveyed 3,000 workers and reported in December that unpaid overtime was seen by most as the norm in these recession times.

The market research company, GfK NOP, highlighted, indirectly, a flaw in pay restraint systems: the problem of suppressed incomes on the most skilled. Surveying 4,000 employees, the company found that 13% planned to leave their present posts ASAP, and a further 11% would leave within the year. This translates in to 6m wanting to move in the next 12 months. Moreover, rather than releasing someone but shifting to shorter hours would slow the flow of workers from job to job so a job-matching problem emerges: a highly productive worker remains too long in the less productive job. In Germany, this has meant that unit labour cost has risen by 6% over the year to Q1 2009.

Unemployment

Unemployment stood at 2.46m in the quarter to September (7.8%). The increased was the lowest for 16 months (30,000). The claimant count was 1.64m, up by 12,900 in October. The number of 16-24 years old was 943,000 (19.8%) and the number of

long-term unemployed was 618,000. The number of non-participants increased by 41,000 to almost 8m.

Unemployment in the quarter to May was (2.47m, 7.8%). Youth unemployment was 923,000, long-term unemployment was 787,000 and there were 8.1m non-participants. Despite the fluidity of unemployment, the picture over the year was broadly similar. Unemployment had fallen by 34,000 whilst non-participation and youth unemployment had fallen by 62,000 (8.1m) and 5,000 respectively, which meant jobs must have been created. An extra 54,000, though, had been added to the long term sick numbers (2.07m).

The corresponding employment story however, was more interesting. With 28.98m in employment, the number jobs had risen by 160,000. There were 22,000 fewer full time posts (18.4m) but the large increase was in part-time work, (117,000 to 6.63m) compensated for that. There were also 59,000 more self-employed (3.93m). Output during the recession fell by 6.4% whilst employment fell by a more modest 2%, consistent with the shift to less than a full working week to preserve jobs.

The British Chamber of Commerce reported in December the pay freeze would continue as half of firms were cutting back on benefits and 58% were freezing or 4.7% were cutting wages. In the event, earnings to May including bonuses rose by 2.7%. The rate in the private sector was 2.7% and in the public sector it was 3.2%. Excluding bonuses, the total growth rate was a more modest 1.8%.

Total of working age plus workers of non-working age = 28.98 + 8.1 + 2.47 = 39.55m. The employment rate was 72.3%, the unemployment rate was 7.8% and the non-employment rate was 27.7%.

160,000 = 117,000 – 22,000 + 59,000

From the figures reported for non-employment, the change in the number of non-employed = –34,000 – 62,000 = 96,000 reduction. Thus, 64,000 are not accounted for. These could be migrants, retirees and those leaving school. (Note the numbers do not add up perfectly.)

Using unemployment or employment rates to indicate the size of the output gap is problematic. Excess demand should result in a fall in the former and a rise in the latter, possibly accompanied by rising wages. The obverse is expected in a period of recession. However, shifting from full to part time could be a life-choice or a sign that there are fewer job opportunities. A fall in unemployment may reflect increasing demand or a reduction in participation. Higher wages in an era of wage freezes could be based on an efficiently wage argument: it pays to increase wages to retain staff difficult to attract.

Predictions of inflation based on excess capacity would normally suggest that with potentially 3m unemployed and a record 8.19m non-employed, there is spare capacity to produce. However, unemployment may not be a good measure of the scope to expand production. Why? First, the economy could be at full employment at 3m without work. These jobseekers may have the wrong the skills, live in the wrong area or be too slow at locating the opportunities available. The natural rate of unemployment is a rate that exists when at full employment. The most likely possibility is that the skills mismatch problem may have a spatial dimension. The wrong jobs are created in the wrong part of Britain for the jobseeker: hence, the Duncan-Smith solution.

Second, capacity should be linked to the machinery available to work with. In a protracted downturn, machinery is scrapped and firms go into receivership, damaging the supply chain. Another dimension emerged in a BofE's quarterly review suggests that some inflationary pressures might be due to less excess capacity than anticipated: the supply chain has been damaged. The CBI, in November, reported that 76% of large firms (employing over a million workers) were more concerned about the well-being of their suppliers. As a result, 68% reported that they would strengthen their relationships with their suppliers. In the US, MFG.com, an online clearing house for manufacturers found in Q2 that 42% of SMEs had received queries from larger companies in need of assistance due to supply chain problems and 51% of large manufacturers reported they, indeed, have such supplier problems.

R3 reported that, with corporate insolvencies over 2008-2009 by sector, the greatest number was found in real estate (12,050) and construction (7,184). When analysed on the basis of number of insolvencies/100 firms, hotels and restaurants had the greatest rate (1.7%) with manufacturing second (1.6%). These two findings are linked to the housing industry and discretionary spending. Manufacturing is worrisome given the enweakened pound. R3 suggested that there is an insolvency lag. Kim Stubbs of BDO suggested that traditional insolvency data may not be reliable. Banks are keeping firms on life-support, maintaining resources in firms and industries that may not have a long term future. In February, Barclays took an unusual step. To avoid a forced sale and a significant write-down on a loan to a developer in Chiswick, it decided to invest more funds into the project, in effect they themselves becoming a builder. They appointed John Lang LaSalle to manage the project. This could be a way forward to avoid what could be another crisis in banking.

Some property companies have survived by using interest rate swaps, which present the banks with a liability if the arrangements are broken. Perhaps because of this liability, banks have been allowing members of the construction supply chain to utilise the creditworthiness of the lead contractor to fund suppliers. With the normal invoice period, companies can approach a factor to bridge the gap, for a fee. By June, the fees had sky-rocketed. With the extension of invoice periods, suppliers were put under strain. For a 10% fee, banks have been helping construction companies survive. This helped some but not all. In Q1 2010, 674 construction firms collapsed.

Third, the size of the informal economy could vary. It is pointed out that a high direct tax rate leads to tax avoidance and a bloated informal economy. The informal economy is likely to grow in a recession. Friedrich Schneider estimated that illicit trade would grow from 10.1% to 10.9% of UK GDP by the end of 2009. This compares with Italy and Greece at 25%, Germany at 22%, US at 7.6%, Switzerland at 8.3% and Austria at 8.5%.

In the UK in 1970, the amount of physical cash as a proportion of GDP was 6%. With innovations, such as the credit card and cash dispensers this fell to 2.4% in the mid 90s. However, now it is at 3.2%. Recently, notes and coins (M_0) have grown as more people use cash – perhaps to avoid the tax man, perhaps because the opportunity cost of holding cash (savings) is not great, or holding cash is safer than putting it in a bank with questionable stability. By contrast, the Irish central bank issued half number of coins in 2009 compared with 2008 and took a further €23m worth of currency out of circulation. Not only did shops and pubs process fewer cash transactions, but it is believed that there was dehoarding of coins: the Irish literally raided their piggy banks.

Of particular interest to a cash-strapped Greek government is tax avoidance. The clampdown on tax evasion started with the Greek Tourism minister, who was forced to resign. Seventy finance ministry officials, each with a property worth an average of €1.23m declared an income of, on average, €50,800. Several doctors with two houses, two cars and even boats claimed an income of €15,000. In Italy, it is estimated that €30bn (or 2% of GDP) of VAT is uncollected each year.

Interestingly, Deutsche Bank found that tax avoidance can work in a country's favour in a recession. Greece, with a government being accused by its leader of being systemically corrupt, was faring better in the recession than the EU average. Being cynical one might question the figure, but with the growth rate of –1%, Greece shrank by 3% less than the EU average. Indeed, those countries viewed as honest, such as Austria or Holland performed well as well. Perhaps we have some

sort of Laffer curve, where being neither corrupt nor honest, such a Germany, placed them in the worst position for growth.

Fourth, in the UK the number working past retirement age is 1.4m: 450,000 men are in work that are over 65 and 953,000 women are beyond 60. Over the year to November, that element of the workforce increased by 5.8%. The ONS estimated that in Q2 2009, 22% of men over 65 and 15% of women were economically active. In the age group 60-64, the corresponding figures were 59% and 35%, with this last group over retirement age. Indeed, the CIPD found from a survey that 71% of those aged 55 planned to work beyond retirement age, which was an increase on the 2007 proportion of 40%. This could reflect disrupted plans (as mentioned in *Update 09* in the US) but also the loss of the employer-provided pension. Under half of those surveyed were members of a pension scheme with their current employer.

The Nation's Savings Habits

The saving trends reported in *Update 09* continued. ONS detailed that, in Q3 2009, the savings ratio rose again from 7.6% to 8.6%, suggesting the average household saved £100/month, despite the very low interest rates. The ONS finding, though, was disputed by economists from ING Direct who estimated the saving rate as falling in 2009. Their results are based on the median households, whereas the ONS calculate on the average. As the top 5% account for a third of savings there will be a difference. Mintel found in March that 35% of Britons has less that £500 in saving with 21% with none at all.

The oft-made point about devaluation not leading to a favourable boost due to rising import costs is illustrated by the FT's manufacturing barometer. Involving 57 firms, it found that over ¼ felt worse of as a result of the depreciation of Sterling in the Q4 2009. The most frequently cited reason is a rise in import costs. Many materials are measured in Dollars. However, 35 of the 57 had benefited as this made their exports cost competitive.

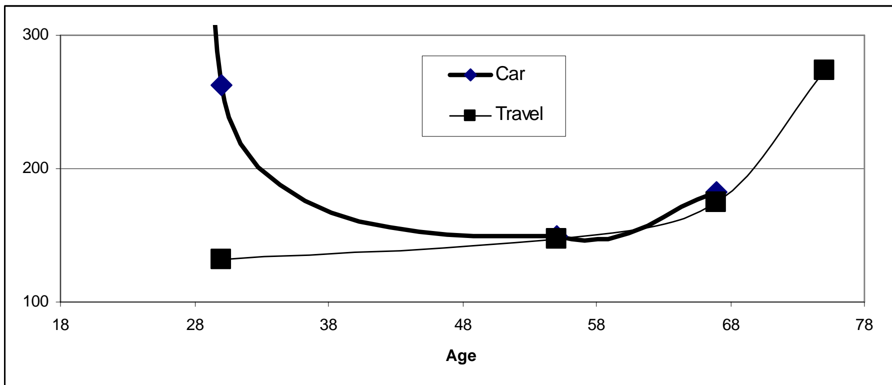
Risk in Action

Insurance companies charge immigrant drivers higher premiums. It was estimated that Admiral quotes on average 18% more. Which? believes this to be racist. One might speculate that insurance companies try to take advantage of information asymmetry and charge those short of information a higher premium, however, there may be a better explanation. The police have noticed a rise in accidents and Kevin Delaney of the Institute of Advance Motorists suggests that new arrivals are less familiar with British traffic law and customs. Indeed, Cheshire County Council has

put up road signs in Polish to address this. Admiral estimate that those drivers not been resident in the UK all their lives generate around 20% higher costs for them from more and greater claims.

QuickQuid, a quick approval finance agency provides overnight approval of loans for up to £1,500 but at a price and this price varies with creditworthiness. For every £50 borrowed the 'good' borrower repays £62.50; the average pays back £64.75 at the end of the month. The APRs are 1,410.33% and 2,222.46% respectively. Some of this reflects the nature of the risk: unsecured loads are inherently more risky than secured ones. But there must be an element concerning who borrows the money. This is aimed at the less credit worthy or perhaps the less credit literate. The new Halifax overdraft charges, introduced in January, sadly are worse. Going overdrawn by £1,500 merits a £1/day charge. Over 30 days this is an APR of 27%: on £100, the APR is 2,333%; and on £50, with £80 to repay it is an APR of 30,441%.

Car insurance premiums for the younger person are almost unaffordable. The figures below, drawn from a Daily Telegraph survey in January, indicate that an 18-year old could pay £3,353 if they lived in London. The lowest group is the 55-year-old bracket. Interestingly, the 67-year-old pays £32 more. The premiums reflect the risk of an accident. Older drivers lose speed of reaction and younger drivers cannot judge appropriate speeds and have accidents.



Worse, the under-29-year-olds are the major group that are uninsured. The Motor Insurers Bureau finds that the group makes up ½ of the 1.5m uninsured drivers. The penalties that courts impose (possibly £50) do not necessarily provide the incentive to get the required insurance.

Another concern is that there is an increase in fraudulent claims driving up premiums. Consumer Intelligence, the research consultancy, estimates that 2010 motor premiums will be increased by 25% to an average of £564 or in total, £2.1bn, as a result. Fraud is not confined to car insurance. The National Fraud Authority estimates that false household claims on average are worth £44/ policy or £2bn/ year.

Travel insurance increases with age. A 18-45 year-old pays £13.24 for a week's travel insurance in Europe: the 75-year old pays twice that. Clearly the older person is viewed as a higher risk. Their medical history is more likely to have a major incident within it.

The June Budget

As mentioned elsewhere, the UK budget of June 2010 entailed a series of radical proposals. Covering 2010-11, it projected the following numbers

Government Income:	£548bn
Government Expenditure:	£697bn
Government Deficit:	£149bn

Income includes: income tax £150bn (27%); £99bn NI (18%), £81bn VAT (15%), Excise Duties £43bn (8%).
Expenditure includes: £44bn in interest payments (6%); health £122bn(18%); welfare £194bn (28%), education £89bn (13%).

To address the overspend the plan was to engage in expenditure cuts and tax rises amounting to £113bn of which £73bn was announced by the Labour administration in their budget in March. In addition to the £21bn tax increases planned by Labour, the Coalition added £8bn. The corresponding figures are spending cuts are £52+£32bn, and £18+£2bn for capital spending.

Regional Policy

A new government and a financially difficult backdrop allow some ministers to think the unthinkable. Well, perhaps not. There appears to be a return to the early 1980s in some ways. A most interesting innovation was the introduction of a spatially differentiated national insurance burden. For those outside Eastern, South Eastern and London regions, the first £5,000 of NI contributions for up to 10 employees in the first year in the job. It was later announced that Regional

Development Agencies and then the Government Offices for the Regions were to be wound down. Civil Service pay was to be determined on a regional basis. Around ¾ of the 520,000 civil servants were based outside of the South East and relative to the private sector, the favourable pay differential is significant (5% for men and 11-13% for women).

Welfare will Work Policies

Cuts in benefits for housing and disability were announced, and a stricter test for disability payments was included in the reform programme. The latter is not radical in that things were already in train. Over the months since the introduction of work capability tests in October 2008 to August 2009 68% of the 189,800 claimants have been placed on the unemployment register. Indeed, 38% gave up their application. This could be viewed as unnecessarily harsh and complex. It emerged in October that the new disability benefit test meant that only 10% of new applicants qualified as unable to work with the remaining 21% eligible for a smaller payment but *encouraged* to look for work. The rejection rate from the medical test for Employment Support Allowance was around 68%. The Disability Living Allowance had a rejection rate of 50%. The aim was to retest 3m claimants, with the expectation to remove 600,000 from the benefit.

The cost of housing benefit had risen 50% to £21bn in 10 years. Placing limits of £280 a week for a flat, and £400 a week for a house, would save £1.8bn/ year. The most interesting policies concerned unemployed council house dwellers. Ian Duncan Smith announced that there would be a flexible response to those unemployed council tenants seeking to relocate to where the jobs are. Someone unemployed would receive a 10% cut in their housing benefit if they had been out of work for over a year. Also, the rents would shift from the median to the 3rd decentile with caps on the payment related to the type of accommodation. There were 4.5m HH in the private rented sector on this benefit.

This radical spatial relocation policy, on the face of it, cannot work. Dwellings need to be exchanged. Why would there be a double coincidence of wants? One suggestion was made in July. All of the 2,000+ social landlords should be forced to form a giant consortium, nationally, so that tenants can avail themselves of the new policy. There needs to be a system of national exchanges of social dwellings. One can see the logic of Circle Anglia's proposal. About 150 social landlords were part of the system called House Exchange facilitating 500 moves a month. Individuals sign-up for an exchange of their property for another of an 80,000 dwelling stock. Circle Anglia estimated that half a million of the 3.9m social tenants are unable to move. The value placed on this restriction was £500m in total, of which: £300m

concerned those moving to care for relatives, reducing NHS and social care; £18m gained from those moving to better jobs; and £48m for fewer benefits and higher tax revenues from those that move to secure work. Thus, the case is more about care than jobs. But how is this consistent with the aim? Preference for housing will have to favour job seekers to be consistent with a neo-classical migration model.

One might anticipate a Coasian approach to this locational problem. As migration is not costless and there may be an existing locational preference, to overcome the greater desirability of the status quo, a bribe could be offered to the sitting tenant by either the one seeking to move or offered by the state. The obverse, a penalty for not forgoing their accommodation may be politically unpalatable, but then IDS is cutting housing benefit from the long term unemployed.

We can predict two outcomes from these polices

First, with less housing benefit, the impact would be to drive down rents. Correspondingly, house prices will follow. Second, the gap between the claimant count and the ILO definition causes some consternation. It was explained in October as reflecting a 'hidden' 261,000 students being defined as unemployed. This constitutes a quarter of the 16-24 year olds in the ILO count. Another factor mentioned was the unwillingness of second earners to sign up for unemployment benefit. Willingness to work is a function of unearned income. The cutting of disability benefits will affect the willingness to participate in the labour market. The unemployment rate will rise. Also, with lower benefits, wages and disposable income will fall.

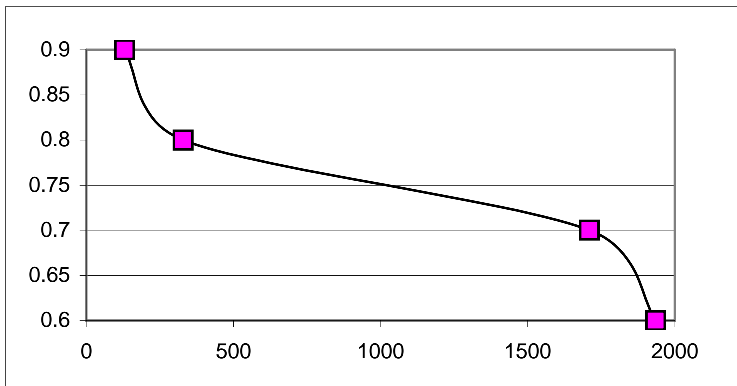
The IFS suggested that the June budget was not a progressive budget as claimed. Those households in bottom quintile would be just under 8% with the richest quintile experiencing just under a 3% reduction. This is a result of changes in taxes benefits and services. This comes on the heels of the news that, as discussed in *Update 09*, those professions that have experienced the highest rise in claiming Job Seekers Allowance over the two years to April, such as Architects (720%), were associated with construction. The greatest number, though, were found among lower skilled work, such as Sales Assistants (110,000).

The Distribution of Jobs

In the UK there are about 19.5m households. Of that number about 14m are characterised to be households of working-age people. In tax and benefits reforms announced in July there was a target of workless gettos. The distribution of work among households is far from even. In the second quarter of 2009 there were 4.8m

working-age people in workless households, which make up ⅓ of such HH. With them are 1.9m children, making 6.7m people or 12% of the population. High-risk workless categories are lone-parent households (40.4%), and one-person households (30.1%).

There were 2.6m people that had spent at least 5 of the previous 10 years on an out-of-work benefit (disability or job seekers). There were 2.4m households receiving working tax credit. Poverty and benefits are strongly linked. 40% of families with children experience poverty in a 3-year period and work is not necessarily a saviour as 35% of families with children remain in poverty when a parent finds a job. Part of the problem is related to the marginal returns from coming off benefits. With an estimated rate of 0.1, i.e. for every £1 earned from working only 10p remained with the earner, 130,000 people would experience a marginal rate of benefit cut and tax increase of at least 90% in 2011-12; 330,000 would have a corresponding rate of at least 80%; and just under 2m would have a rate of 60% or higher.



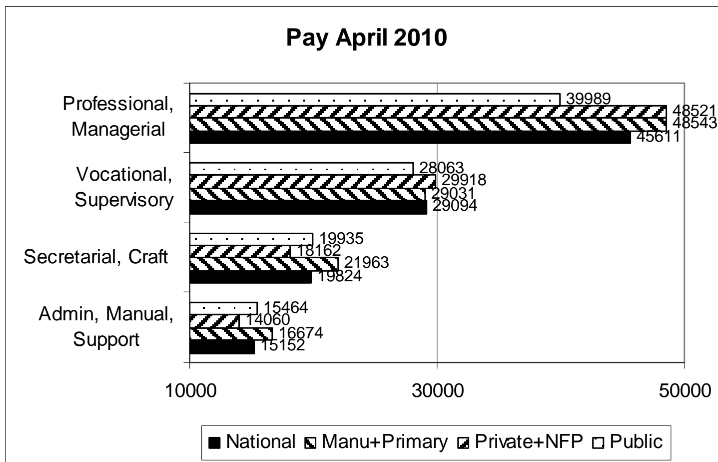
Although it is not that straightforward, getting people into work is a logical way of reducing poverty. Given the above, the marginal penalty from working is too high. Looking to a Laffer curve type analysis, the penalty rate must be reduced. This means reducing benefits relative to minimum wages. One suspects that minimum wages will not be adjusted upwards.

Despite an average wage gap of 12.2%, Cambridge University found that in 2006-7 44% (6.2m) of households the wife brought in as much as the husband and 19% (2.7m) earned more. This, it is suggested, is related to the rise in female qualifications. A concern, here is the rise in the number of double-earner and no-wage income households. The gap between the rich and poor would expand and, through the education system than helped women, cause the Labour Party more

concern over inequality as this would favour the new enriched educated 'post-working class'.

In total, 1m households (6%) had resorted to using credit cards to pay their housing costs (mortgage payments or rent) in 2009. Shelter found that 8% of socio-economic categories C2, D and E and 4% of ABC1s engages in this foolish, desperate practice.

The figure below shows the Daily Telegraph/IDS pay index for April (2 6 10 pB12). The pay by broad group is not identical. The managers and professionals earn, on average, 3× what administrators, manual and support workers are paid. Also, the construction, service and not-for-profit group (NFP) generally pay less at the bottom end and the public sector pays less at the top end.



Taxing can be Taxing

Harold Wilson quipped once that a week was a long time in politics, but it strikes one as short time for a tax policy, but the Compulsory Insurance Plan for Dog Owners, takes the biscuit. It lasted just over a week in March. The idea was to address the problem of dogs being used as weapons. But the sledge-hammer-nut proportions weighed against it. Presented as a tax on dogs, at a time when stealth taxes were likely to be a hot issue in the run up to the election, the proposal was dropped. The requirement was anyway unenforceable. Expecting those that have attack/ dangerous dogs to register them strikes one as unrealistic. A duty increase on cider announced in the March budget was scrapped in April as the rush to get something though the Commons before the election in May.

Basic Regional Ideas

The nature of spatial economic policy is at a crossroads. At the European level, there is a blurred view concerning the redistribution of wealth from the rich to the poor countries. At the national levels, many local authorities in Germany, Italy and the US are in financial difficulties. In the UK, the Coalition government is shifting back towards a 1980s style to regional policy – which implies a dismantling of it.

Below is a broad discussion of regional economics ideas and practice in the UK. The government appears to be shifting towards a redrawing of spatial policy, possibly based on functional connections, rather than the existing contiguous, but not necessarily economically-linked, counties.

As the University of Lincoln is based in Lincolnshire, that county will be used to illustrate the problems of delineating a space for economic policy purposes. As an introduction, some indicators of Lincolnshire, and its region, the East Midlands are discussed.

Lincolnshire's Income

Depending on the measure used, Lincolnshire is one of the poorest counties in the country. By NUTS2 in 2007, Lincolnshire had the second lowest GVA/capita at £13,972 (inner London £57,180) but also has a relatively low unemployment rate. House prices appear quite inexpensive, but with even more modest wages, housing is relatively less affordable compared with the UK average. It is sparsely populated, with Lincoln being the largest population centre with around 100,000 inhabitants, not really a city by UK standards. Like other sparsely populated areas of the UK, it is an agricultural county, (the location quotient is very high) and as such, that broad group of produce constitutes a key export to the rest of the world. Sadly, over the period 2000-2007, GVA/head at current basic prices fell from 74.4% (£6,811) of the UK average to 70% (£9,679). It also fell relative to the East Midlands. For Lincolnshire, the agricultural GVA fell in absolute and relative terms from £459m (6.7% of the total GVA) to £408 (4.2%).

The Gross Disposable Household Income (GDHI) picture offers a different story. In 2008, Leicester (£11,217; 75% of UK average) and Nottingham (£10,361; 69%), were in the bottom 5 of the NUTS2 regions in the UK when Lincolnshire (both a NUTS2 and 3 region) was £13,187 (88.7%). As suggested in the discussion on house prices, cities suffer from in-commuting. The wealth generated in the cities is 'commuted' to the more rural areas. Poorer people tend to live in inner cities,

pushing down the estimate. Richer people live outside, in more rural fringes, pushing up prices. For Lincolnshire 2000-2007 GDHI/head at current basic prices fell from 91.4% (£10,191) of the UK average to 89.4% (£12,805). It fell relative to the East Midlands.

Regional Views of the World

To a great extent, the economic policies put in place depend on the view of the local economy. Let's look at two conflicting views. **Balanced Growth Models** view the local economy like a mini version of the national one. The primary driver behind economic activity is the local's own economy so a poor performance is related to weak economic or business management, or inflexible, poorly-skilled workers. This approach presumes that everywhere has the same capability (an identical potential production function), so that it is possible for every part of the country to reach the same level of income per head, if things were done properly. This appears to be the Coalition's and the former Labour government's view.

Central to **Imbalanced Growth Models** are concentrations of populations and businesses. Terms and ideas that are used in this world are core or centre and a periphery. The core could be London/ the South East, or on a more regional basis, it could be a city of significant population (250,000+). In either scenario, rural areas are viewed as the periphery. The concentration of firms and people give the city an advantage over the rural area. Economies of scale and scope bestow the city with profitability/ productivity advantages. Localisation of production and population enhances information flows that help technological development and the expansion of markets. Operating above a minimum efficient scale of both production and markets, the city fosters specialised suppliers of business services, such as financial, legal and consultancy work: specialised implies more productive. Also, there is a relatively large pool of labour with a broader variety of skills and talents. A city pays higher wages and offers more job opportunities.

Producing Locally

The above discussion makes no mention of what is produced locally. From *Update 08*, export base models posit that local growth is strongly influenced by what is produced and 'exported'. For example, an area that concentrates on coalmining is unlikely to grow as rapidly as elsewhere. Viewing Lincolnshire as a small country, its exports should pay for its imports. Using this simple export base view, exports will grow as their markets grow, and income grows as exports grow: the non-exporting internal market cannot grow independent of the export sector. Thus, growth of the small country depends on the goods and services that are exported and

the income of external buyers. For Lincolnshire, if it concentrates on exporting goods that are not income sensitive, such as agricultural products, as buyers get richer, exports do not grow as rapidly, restricting its capacity to import and, hence, limiting the development of the local economy. Thus, an agricultural economy grows slowly and has a relatively low GDP/ head.

Core-Periphery Divide

When the urban and rural are put together a systemic problem emerges. With the offer of higher wages, the core attracts the best and most productive workers from the periphery. Savings deposited locally, unless committed locally, with greater profit opportunities, will flow to the core. As funds can flow to London from elsewhere, this is made worse in the UK with a highly concentrated banking system. In other words, the city or core, through the migration of skilled and talented workers and innovative or cost advantages, denudes the periphery of its productive capacity. This extends the gap between the core and periphery. Thus, the periphery grows slowly and has a relatively low GDP/ head because of the core.

Despite the low GDP/head and modest wages, Lincolnshire's (rural) unemployment is low also. The local culture has a relatively flexible attitude to work. The history of low-paid manual work is known to international temporary and increasingly, permanent, immigrant workers. The immigrants compete for the low skilled work, driving local wags down. Those local low-skilled workers on modest wages lose out to the richer commuter when competing for a house.

Through retirement, tourism and commuting, there is the spreading of economic activity from the centre to the periphery. The rich prefer space and attractive environments. There is a tendency to work in the city but commute from the country. Thus, rural on the fringe of urban areas will have higher house prices than otherwise. The rural idyll draws in those retiring and the tourist, but these do not work in the county yet still need accommodation. Thus, housing is less affordable than elsewhere, despite low unemployment.

Working Together

A united and well organised network of institutions that support local firms, such as financial institutions, charities, local chambers of commerce, training agencies, trade associations, local authorities, innovation centres, clerical bodies, unions, the University, colleges, newspapers and development agencies, and so on, must work to forge a common and realistic view of the future. The thinking around new industrial districts and social capital offers some hope. Social and human capital can

be enhances through interaction. This tends to favour cities, as 'buzz', physical interaction is based on distance: rural areas operate in a dispersed field. However, the new media of mobile computers can mitigate this to a great extent. Key, then, to addressing population dispersal is broadband or high quality mobile phone links. Indeed, one might argue that Cameron's big society fits in here somewhere.

Conceptualising Core-Periphery

Thus, it is contended that there is core-periphery or a co-dependent relationship between London/South East and the rest; between urban and rural; or between a city and its hinterland. Borgatti and Everett (1999) suggest approaches to the modelling of core/periphery structures using linkages. Central to their discussion is a network relationship that exists between elements of their monocentric, two-tier [regional] system. Core regions are strongly linked to each other whereas peripheral regions are weakly connected, having stronger bonds to core, rather than to other peripheral areas.

Using the Borgatti and Everett (1999) framework, the table below represents the relations within a theoretical five-region system containing two core regions, 1 and 2. A link is indicated by coordinate a_{ij} = 1, no link = 0. Both 1 and 2 have links with all other regions but 3 to 5 are not linked to each other.

	1	2	3	4	5
1		1	1	1	1
2	1		1	1	1
3	1	1		0	0
4	1	1	0		0
5	1	1	0	0	

If a core-periphery model best characterises the area concerned, it makes sense to delineate the economics and policy space on that basis.

Urban Systems

A national urban system comprises a hierarchy of cities or nodes, arranged by size and function. The number of centres and their populations are inversely related. Within the national system are regional sub-systems, which, again, are made up of cities but also towns, also arranged in some hierarchy, but the clarity of such an order is not so apparent. The pinnacle could be a single metropolitan area. As with a Russian doll, a lower order system is set within the regional. A daily urban system represents the 'life space' of urban residents. In the UK national system, London holds the mantle of the city at the top of the hierarchy of cities, with the greatest

number of corporate headquarters and the largest service sector supporting them in terms of such legal and financial services. It is the largest city by population by a factor of eight. Its commuter belt is the most extensive with the most comprehensive infrastructure to support it. It contains the boroughs with the highest house prices. London is linked to the second tier cities such as Leeds-Bradford (Yorkshire-Humberside), Manchester (North West) and Birmingham (West Midlands) via superior quality infrastructure, such as motorways and swift rail links. Third order metropolitan areas would be Liverpool (North West), Sheffield (Yorkshire-Humberside) and Newcastle (North). Thus, we can see a more sophisticated version of Borgatti and Everett framework implicit in an urban system model.

City-Regions

Nodal-oriented approaches have been proposed to dividing up economic space in the UK. Cheshire and Carbonaro (1996) define Functional Urban Regions (FURs) as concentrations of employment or core areas supplemented by all spatial units from which more workers commute to the core areas in question than to some others. There is a core and a hinterland. The core and periphery are, in a sense, part of a housing market area (HMA), with many sub-markets. DiPasquale and Wheaton (1996) state that a HMA should encompass real-estate parcels that are influenced by the same economic conditions. They delineate HMAs around labour markets: a HMA is derived from workers being able to substitute residences without changing jobs, or switching jobs without moving home. Robson *et al*. (2006) explore the delineation of city-regions in a series of reports for the Office of the Deputy Prime Minister (ODPM) which you can find on what was the Communities website. These are detailed containing theoretical and empirical work. In Mapping City-Regions Report 1, they discuss the delineation on the basis of housing and labour markets. They consider a top down deductive and an inductive approach to delineation.

The inductive is based on a relatively self-contained spatial pocket of 100,000 jobs. Clearly, the greater the self-containment threshold employed, the large the region. Working on 70% self-containment, they identified 71 regions, but with 85%, the number falls to 36. Using only professional/manager groups, who have a greater propensity to commute large distances, the 85% threshold produces only 19 regions.

The top-down approach is non-exhaustive, so that not all of England would be allocated to a City-Region. Nodes are identified based on employment base, retail flows and three other definitions drawn from the literature. Given five definitions, a node is one that falls into at least three of the lists. After some shortening of the list, they opted for 39 nodes.

Again, examining flows between districts, they found that 15% flows would encompass the whole map; but when the threshold increases to 25%, there is no district associated with more than one City-Region. Comparing the top-down approach with a 25% threshold and the bottom up with an 80% containment, the two compare well.

Polycentric regions would/ could emerge from such an exercise. Rural areas without a dominant node but a number of smaller centres, such as Lincolnshire, could be distinguished from regions with towns, such as Burnley, that cater for less skilled workers, but professional/ managerial group commute further to a major node nearby. Another form of polycentricity occurs with a large node that overshadows a number of smaller, competing nodes. The best example of this is London.

As Robson *et al.* point out, house prices are an indirect means of identifying dwelling exchange activity within an area and, hence, the extent, or containment, of a HMA. They analyse residential churn to highlight a market. Churn entails using migration to or from a district. The largest proportion of movements is revealed to be short and, so, local, and influenced by communications. Commuting will vary with occupational group. Drawing a set of boundaries based on professional/ manager groups would lead to fewer, larger regions compared with the same process undertaken for semi-skilled workers. Employment nodes, such as large cities, would, thus, have different catchment areas depending on which group was analysed.

Other measures that Robson *et al.* utilise include cultural and recreational flows to the major cities to delineate two City-Regions, Bristol and Manchester. Along with the use of professional managerial migration and commuting patterns, they illustrate the shadow cast by core cities for employment as well as major cultural and entertainment events and the difficulty in defining regions.

New Policy Spaces

At the time of writing, the government is drifting towards self-defined economic policy areas, Local Economic Partnerships. Consortia of local authorities are expected to band together for the common good. If the choice is based on self-interest, the alliances are likely to be based on: common problems; contiguity; co-dependence; or a mercantilist, what we can get from a richer party. Following Robson *et al.*'s work, not all local authorities will find a consortium to join that is contiguous and a city-region map will cover not all spaces. It is suggested here remote rural ones will fall into this category.

Policy View

The discussion of polycentric regions suggests that rural areas might struggle. Their issues will be distinct from a city-region. Central government policy can present a challenge for remote rural areas, such as Cornwall, the Highlands of Scotland and Central Wales, which suffer from similar problems as Lincolnshire. Current thinking seems to favour a Balanced as opposed to an Imbalanced Growth approach, which, if inappropriate, is problematic. Worse, remote rural areas could fall through the policy cracks. With a sympathetic view of rural problems, these areas will struggle to keep up with others. Treating it as the same as elsewhere, or, worse, not providing central government support at all, does not bode well for such economies as Lincolnshire. From the income figures above, Lincolnshire is falling behind other NUTS2 regions, even locally. This is to be expected if nodes/ cities are the key engine of growth. Without the redistribute nature of interventionist regional policy, it will fall further behind.

The Future of Lincolnshire?

If endogenous growth is the only reliable source and there is a path dependency in growth, alternative regional growth models could be helpful. To put the county on a more favourable path, Lincolnshire policy makers could push to increase its population and improve communication links. A better-educated workforce, either from the University, or the schools and colleges willing to live with more modest wages for the benefit of very attractive quality of life, should draw businesses offering high value-added jobs. Financial institutions can commit to retaining all locally deposited savings within the Lincolnshire economy. Savers could pick and choose their financial institutions on that basis. Indeed, as discussed in previous *Updates*, some areas have introduced their own currencies. A highly socially-networked, creative space may compensate for Lincolnshire's disadvantages. Whether this is achievable is another matter.

Specialisation

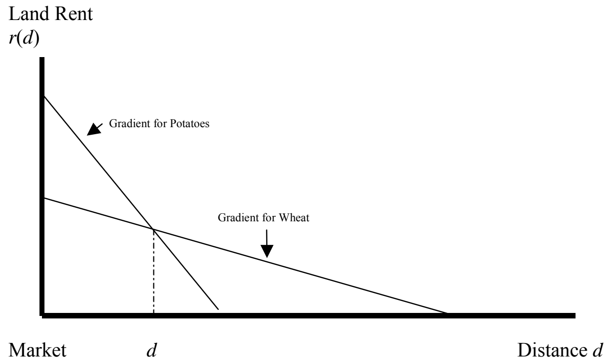
The much vaunted clustering of businesses, first brought to attention by Marshall with external economies of scale, next with the new economic geography, untraded interdependencies, and Porteresc industrial clusters were advocated as a means of accelerating growth and innovation. However, geographic specialisation that forms the basis for regional economics may be an advantage as the industrial cycle is in the growth phase but during an economic or industrial decline, specialisation can

concentrate disadvantage. Worse, the network economies that interdependencies supply can also offer diseconomies: a domino effect may occur where failure of some produces may destablise other members. Teeside saw four of its six petrochemical companies announce in 2009 closures releasing 1,000 workers. The interdependency between Dow Chemicals and Croda can be illustrated. Dow announced that it would shut its ethylene oxide plant. As a result, Croda, who buys this dangerous substance, announced it would move some production to continental Europe to be closer to the supply of that input. Dow's decision to close the factory was due to falling price of another product, monoethylene oxide. With these two companies going, TDG, a logistics company that stores and transports chemicals was considering making 48 of its 56 drivers redundant: a negative multiplier effect.

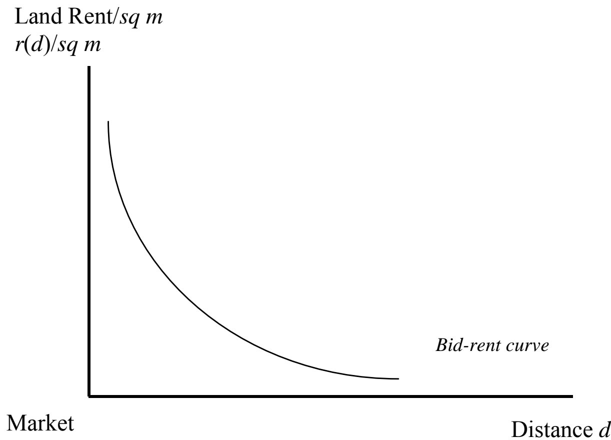
Specialisation to the point where a city was a one-product/ company town was a Soviet strategy. There are around 400 monogorod under review by the Russian government. A cement city of 22,000, Pikalevo, was badly hit by the fall in cement prices since 2008 and has ⅓ of the workforce unemployed. Nizhni Tagil (450,000) and Zlatost (190,000) are iron and steel cities adversely affected by the collapse of metal prices. The largest, Tolyatti, is the car producing base of Avtovaz. Struggling to survive and desperate for Renault, its 25% owner, to do something to support it, the company was considering making 25% of its 102,000 workers redundant. With a population of 700,000 this would be significant. If only half the population work, this one action will reduce the number of jobs by 7%.

Urban House Prices

To explain the nature of a (sub)regional labour market, it is instructive to discuss how urban house prices are modelled in a simple neo-classical type model. In early work by Von Thünen, where access to market altered the returns to agriculture, land rents are modelled as a negative linear function of distance to market. He proposed rent gradients with negative slopes, reflecting transport costs. The analysis could be made more sophisticated by including more than one agricultural product in the model. This, then, provides the basis for allocating crops to fields at various distances to market. By implication, this is a means of segregating space. Take, for example, the cost of transporting potatoes and wheat. Assuming the price but also costs of transporting potatoes to market are higher than wheat, the diagram below could be envisaged. It is more profitable to cultivate potatoes up to point *d* so the rent that could be paid is higher. After this wheat is less costly, so it will be cultivated there.



The bid-rent model due to Alonso (1964), Muth (1969) and Mills (1972) develops the Von Thünen approach by allowing land and non-land factors to be substitutable, whereas Von Thünen presumes the relationships are fixed. Thus, with factor substitution and a given profit rate, a farmer can choose among a range of sites so that when land is expensive, other factors will be employed in increased proportions. The bid-ret curve is convex to the origin.

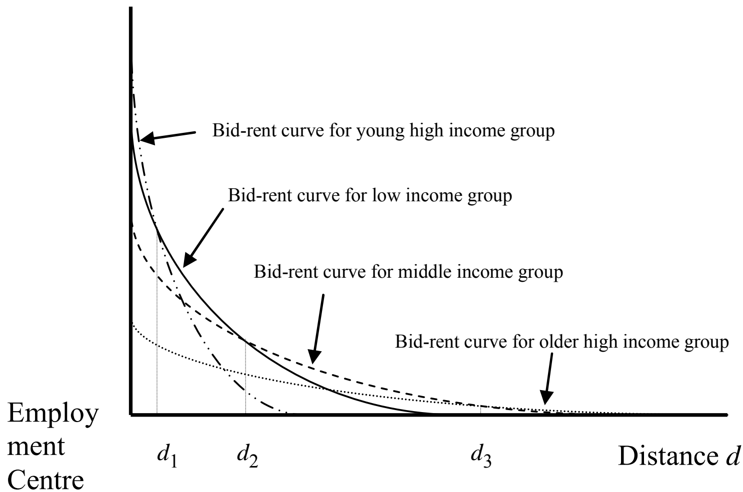


Given a rate of profit, profit maximisation and efficient allocation of factors are implicit in a bid-rent curve. Lower land rents imply lower costs and, hence, higher profits. With a higher given rate of profit, the bid-rent curve shifts inwards.

Land is owned by landlords that rent out their property to the highest bidder. As with Von Thünen analysis, the bid-rent model can be used to allocate land among

competing groups to explain urban segregation. Workers commute to the centre. The commuting costs/ unit distance *k*, are assumed to be a linear function of distance, are viewed as 'bad' by all workers. The bid-rent curves reflect constant utility. Lower rent, given a budget constraint, renders the commuter better off. But this is could be undermined by greater commuting costs. In other words, there is an equilibrium differential between substitute areas. As they are willing to pay to reduce or evade commuting to the employment centre and proximity to the bright lights of the city, short distance commuters are willing to offer higher rents. As the demand for a particular space increases 'rent' rises leading to incentives to change the housing stock in that space. The land could be used more intensively with a higher density of accommodation returning a higher rent per square foot. This includes turning larger houses into multi-occupancy flats and building taller properties. This predicts that urban areas will have a greater density and smaller average unit size than rural areas. Density is inversely related to *k*.

Given homogeneity of income and family group the spatial preferences will be plotted along a common schedule. However, this proximity advantage is tempered, by distinct income and family groups, and by the demand for space. Dividing the population into four homogeneous groups; low, medium and high income, but this high income subdivided by family and non-family; the rented property market can be segmented. The bright-lights are assumed to be a major attraction to young non-family, high-income groups whereas the family counterparts favour larger dwellings more than they abhor commuting. These two groups, as the diagram below displays, select different locations. The bright light seekers outbid any other group for high-rise accommodation close to the city centre, between the city and d_1. The high-income family group outbid other groups for large plots beyond d_3. Out-bid by their richer counterpart, the medium income group follows the pattern of high-income families and outbids the low-income group for space – between d_2 and d_3. This latter group is assumed to have severe commuting constraints e.g. by cost, so are limited in the distance they can travel. They occupy the space that the others do not want – between d_1 and d_2. This suggests that high house rents and prices will be found in two areas.



Assuming a strong link between rents and house prices allows us to reuse the above. The above discussion can be used in the context of a New York Times article *High-Rise, or House With Yard?* by Tara Siegel Bernard July 2, 2010. She questions where people's preferences for accommodation might place them and how a life cycle might affect their choice. The question starts to hang in the air sometime after the children arrive, and the apartment in the city begins to feel a little tight: stay put; or move to a house in the suburbs?

The cost of moving from between the city and d_1 include easy access to work, the theatre, restaurants and just the general dynamism of urban living. The benefits of moving beyond d_2 are prospect of more space: a bedroom for each child; a lawn to stretch out on etc.. In the US as in the UK, a good school is an amenity that affects house prices. It can act as a counterweight to the urban centre.

She goes on to say that if the deciding factor is the relative cost of each, the answer is to some extent quantifiable, using an apartment and a house in the New York metropolitan area as cases. A suburban lifestyle costs about 18% more than living in the city but an urban apartment is more expensive than a house in the suburbs. As with the above, there are commuting costs across distance k from the suburbs, or the expense of buying a car (or two) and paying the insurance.

She utilised a hypothetical family of four, where the two parents work, and earning $175,000/ year in July 2010. A two-bedroom, one-bathroom co-operative apartment in Park Slope, Brooklyn, was listed at $675,000, which is a representative price for

the district. As the joys of sharing in the city wane and income rises, space is desired. The life cycle effects of family, plus the salary made a median-price home in Park Slope, which is family-friendly, has good schools and is generally more affordable than Manhattan. This would correspond to accommodation close to the city centre, between the city and d_1, but where k is around d_1.

Moving out to the suburbs of South Orange, N.J and commuting is an alternative. A middle-income group will find space – between d_2 and d_3 affordable. Housing is cheaper and larger. They could purchase a $595,000 four-bedroom, two-and-a-half bathroom home and bear the commuting time/ cost of a 30-minute train ride to Manhattan.

The suburban accommodation's monthly costs were $5,668, including commute to work. The Park Slope accommodation cost $3,852. Property taxes in South Orange, about $16,000 for the chosen house, plus the cost of two cars, monthly train passes and higher utility bills, make the suburbs much more expensive. However, Park Slope family's costs may be skewed by $25,000 a child in school fees, which make the suburb cheaper. Suburbs again score than higher rates of tax are applied to wealthier families. New York City taxes, which, at 3.65% of income above $90,000, especially for families earning more than $300,000, can really add up.

Without the family, preferences alter again. Many empty-nesters are giving up the high-maintenance house in the suburbs in exchange for the attractions of city life. Moving back to Manhattan, this would correspond to accommodation close to the city centre, between the city and d_1, but where k is small. The conveyor belt associated with the life cycle outlined in *Update 06*, can be seen in this discussion.

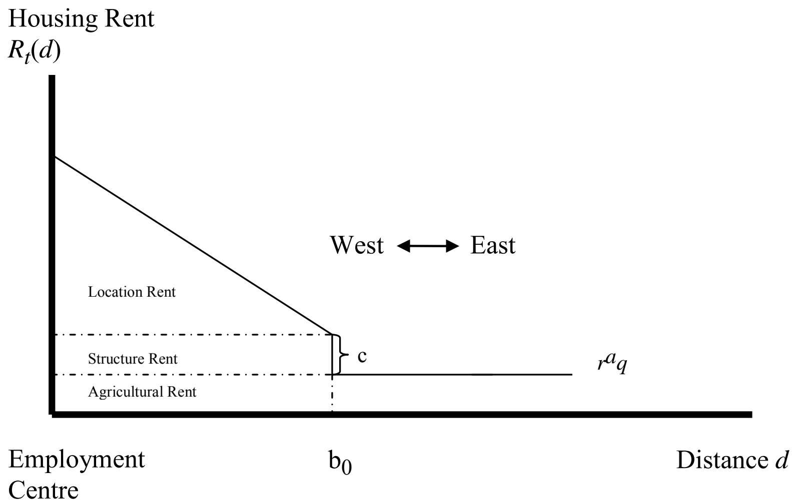
DiPasquale and Wheaton's Urban Housing Model

DiPasquale and Wheaton (1996) aver that the supply of land sets the overall market price level but it is demand that determines relative property values and it is here that attention should be focused when seeking to examine why the prices of land and property vary considerably within the same locale or market. The demand for property in a market is a function of the number of households, [permanent] income and the annual cost of owning property. Although affordability is commonly assessed on the basis of current income, DiPasquale and Wheaton report that permanent income is a better predictor of housing consumption, implying that a life cycle model, where wealth is a key variable, could be useful in explaining differences in house prices across space.

One approach for pricing theory to explain relative property values is based on the flow of utility or services that the house and its location provide. Each dwelling has a bundle of characteristics, each of which are assumed to be homogenous across properties, and can be priced. The premium for property at one location should reflect the present value of the utility from living there relative to other places. As displayed in the figure below, a simple, monocentric city model with a central business district, this premium reflects the disutility associated with commuting to the centre. There is an employment centre and the areas that surround it are residential comprising dwelling units of size q, which is assumed to be fixed.. Beyond the circular residential space is the agricultural zone. Workers, then, commute to the centre and this generates a Ricardian rent. Like bid-rent analysis, this involves relating the rent, $R_t(d)$, or lump sum that a worker is willing to pay to reduce or evade commuting to the employment centre. But unlike bid-rent analysis, this involves a commuting cost function k, which is assumed to be a linear function of distance. The extent of the city boundary is b_0. The closer one locates to the city centre, the greater the locational, and hence housing, rent. An expression that links rent with the above at time t is

$$R_t(d) = r^a q + c + k(b_0 - d).$$

The rent at the boundary b_0, which is the lowest in the city, is determined by annualised housing construction costs (c) plus agricultural rents per acre (r^a). To the west of this, to avoid the maximum commute, Ricardian rents are paid. Here d is measured from the city's edge.



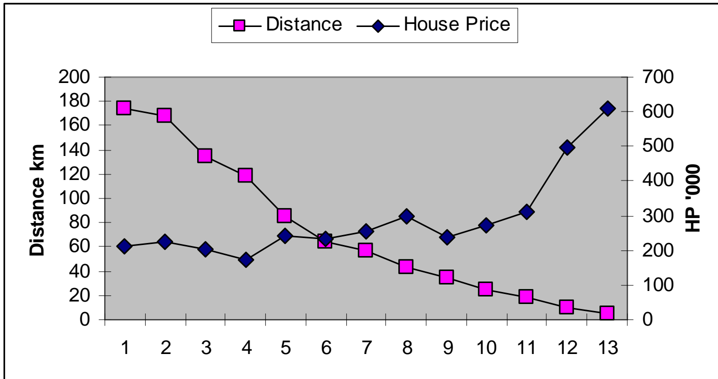
Commuter-Costs

As discussed above, house prices are also a function of distance for the central business district. Commuting in a housing market context is viewed as a trade-off with house price; the utility is assumed to be the same. Here, assume that is the City of London/ London is the Employment Centre/ Central Business District (CBD). We compare average house prices, distance and train commuting times. The places selected broadly follow a route into Paddington Station in London and then on in to the City of London, our CBD.

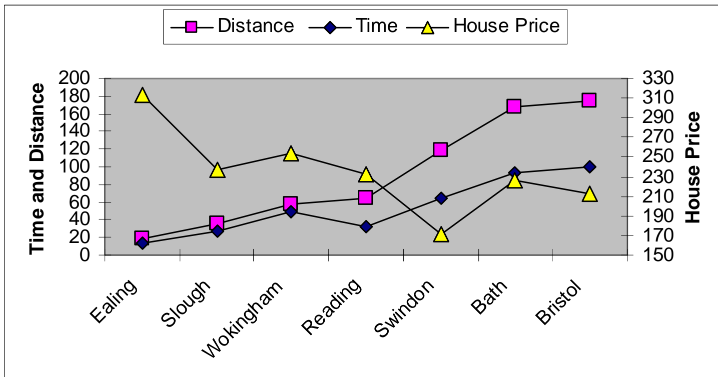
	A	B	C
Bristol	174	213	140
Bath	168	226	133
Wilts	135	201	
Swindon	118	171	65
West Berks	85	244	
Reading	64	233	32
Wokingham	57	254	49
Winsor	43	299	
Slough	35	237	27
Hillingdon	25	274	
Ealing	19	313	13
Hammersmith	10	498	
Westminster	5	608	

A: Distance to City of London
B: Q1 Average House Price
C: Minutes to Paddington by Train

If we were to plot the two variables, house prices and distance to the City of London, the graph below emerges. It shows a fairly clear inverse relationship, consistent with the monocentric urban model above. Distance to London is inversely related to house price (right-hand scale).



Undertaking the same analysis but with commuting time as well. Both graphs do not present a linear relationship; there are a few kinks. These might reflect other (un)desirable properties. Slough and Swindon come out as inconsistent with those either side of them. These house prices are too low for the distance to London. This could reflect less desirable attributes of these urban areas. Also, Reading has a connection that is relatively rapid.

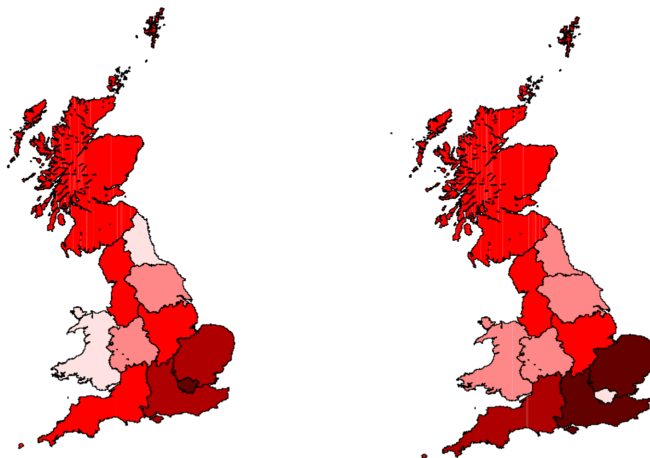


The disutility from commuting has a further dimension. Club Vita, a pensions consultancy, found that for a given gross household income, those that commute from the Home Counties to London have a lower life expectancy. Those that commute from Reading of 108km (36mins) with an income of £807/week have a life expectancy of 79.9 years when the usual span for a Reading non-commuter is 81.3. For an income of £704 the Brighton commuter (71km but 70mins) lives for 79.6, over a year fewer than the 80.8 for a non-commuter. Life expectancy is highly correlated with income. But to earn a higher wage the disutility of commuting also affects life expectancy, so it is not income *per se*, but lifestyle as well.

The Cost of Housing

The Halifax (Press Release 26 6 10) estimated the annual cost of owning and running a house in April 2010. The UK average was £9,020/ year this includes council tax mortgage payments and maintenance. The map on the left, graded by colour (darker implies more costly) gives you an idea of the most expensive - London @ £11,762 and the North East is the cheapest @ £7,331. One would expect that distance from London matters, which it does but only in the immediate (commutable?) vicinity of the South East.

The map on the right, based on housing costs as a percentage of earnings, is broadly similar, but London slips from the top to the bottom of the list at 24%, to below both the North East (26%) and the UK average of 27%. Strangely, this implies that London house prices are relatively cheap compared with earnings. The difference in percentage terms is not that great, as one might predict.



House Price Trends

The ONS estimate of Britain's asset base, its physical and financial assets, was £6.67trn in 2009. This was £94bn lower the 2008. Housing made up £4.05trn of this (61%), increasing its contribution by £126bn over the year.

Savills projected in April that, as sales over 2008 and 2009 were 55% below the 30 year long term trend, there should be sufficient unrequited demand (1.5m buyers) to return the housing market to rising prices and house builders to start construction sometime soon. This, we could regard at the long term prospect.

By contract, in the short run Capital Economics felt that housing supply would cause a problem. Houses that would normally have been sold but, in the recession, were rented, would trickle back onto the market. Capital Economics estimated a backlog of 145,000 dwellings to come on to the market. Hometrack saw an upward move in the supply of housing in January and February, compared with 2009: March saw an excess supply of new housing over new buyers. Compounding this, the RICS found in June that estate agents were experiencing a 3-year high of instructions to sell and weakening demand, leading to price falls. These findings are reflected in those of Zoolpa.co.uk the property website in August. It found that, during the summer of 2010, asking prices were reduced by over 6%, worth £1.5bn. Places such as Manchester, Barnsley and Rotherham had the greatest reduction of 7.1%.

Council of Mortgage Lenders (CML) reported that the number of mortgage approvals were 32,000 in January. This is despite the average interest rate of 3.83% and a 3.97% fixed two year with 25% deposit. The former is the lowest rate and only the second time that the rate has fallen below 4% since 1993 when records began. Approvals to first time buyers of 11,300 were up by 31% over Jan 2009 but down 54% on Dec 2009.

By May, 600,000 mortgagees were estimated to be in negative equity by the CML. Moreover, the BofE found that 1.5m (or 14% of all households) held less than 10% equity in their properties. As such, they could not renegotiate their mortgage with a refinancing deal. As the banking squeeze continued and wholesale was replace by retail financing, mortgage rate rose. The CML reported lending to 42,000 in May of which 14,800 were to first time buyers. The knock on effect is reflected in Shelter claims that in April 20% of childless couples between the ages of 18 and 44 refrain from starting a family because they cannot buy a house. Indeed, the profile of the buyer is changing. The median buyer is older and richer than ever before – 37-years-old (35 in 2008). Their income in Jan 2010 was £42,798 (£39,189 in Jan 2009 and £42,000 in September 2007@ price peak). The loan to value was 70% (74% in Jan 2009 and 80% at market peak in 2008). Cash buyers made up a third of purchasers in 2008 and 9 compared with 25% on average over the decade and the HP: earnings ratio was 2.91 (3.17 in Aug 2007@ price peak).

One of the consequences of a sclerotic housing market is that to expand the living space, owners opt to exploit the loft or the garage. The Bank of Santander estimated that there were about 9.3m private garages. Of these, 7% were already converted and a further 5% were going to adapt the space into an office or spare room.

Housing Environment

The surrounding area has an impact on the value of a house. Consider the consequences of flooding. The Environmental Agency estimated in November that 485,000 houses could become uninsurable as a result of flood risk. This would reduce a house's value considerably. Taking a punt on the lottery is taking a risk that can be repeated. Your house flooding is something you do not really want to bet on. The consequence of being on the wrong side is, perhaps, unbearable.

An application of externalities can be seen in the value placed on a good neighbour. Lloyds TSB Insurance estimated, in April, that in a poll of 2,018 adults, house owners were willing to pay an additional £3,100 for a good neighbour. This is illustrated by an event in a village in Jane Austen country. A farmer, in Ropley, sold up and left for France. A traveller purchased his land for £150,000. A shortage of authorised sites had led to travellers erecting semi-permanent dwellings and then applying for planning permission retrospectively. The new owner, in December, set about converting the site and moved a mobile home and a caravan on to the site. Attempts to prevent this in the short run, legally were thwarted, and local residents faced thousands of pounds of legal fees to pursue the case over a prolonged period.

A Coasian solution was identified. The locals could bribe the travelling family to leave the site. The Ropley Action Group was formed and the 29 households contributed what they felt they could (£1,000-£29,000). The asking price for the traveller's land was £225,000, a £75,000 profit. The villagers, fearing other travellers could further affect their quality of life, raised the money.

Noisy Neighbours

Sadly, wind turbines are not only unsightly but they also emit low frequency noise. Hayes McKenzie Partnership recommended in a draft report to the government in 2006 that, to protect locals, 33 to 38 decibels should be the maximum permitted noise made by wind turbines. However, this recommendation was ignored and a previous recommendation of a maximum of 43 decibels has been adopted for local planning purposes. Evidence extracted by a Freedom of Information petition mounted by residents objecting to a wind farm development found the draft, at odds with the final report. It appears that there was concern from a government official that the more stringent requirement would hamper private sector development. There was a dispute about the number of complaints about the noise in (100 vs. 270) but seven wind turbines have provoked some concern Askam, Barrow-in-Furness. Although there are few examples as yet, the Deeping St. Nicholas farm in South

Lincolnshire has forced at least one household to abandon their home. The number of wind farms was, by December, 253; by 2020, this is expected to double.

Housing Snippets

After the end of the stamp duty reduction, house prices fell following several months of increases. The proportion of annual income needed as a deposit to buy a house in England was at 16% in 2000; by 2009, it was 64%. However, in London in 2009 it was 97%. This is lower than the 153% in 2008.

Second homes sales were worth over £750,000 up 40% in Q4 2009 compared with 10% in the prime regional market according to Savills. In Cornwall, second home-owners make up 43% of primary stock sold in the last 4 years.

In February, reports of banks using even more information about prospective mortgagees' disposable income. Indeed, Yorkshire Building Society was one of a number in effect using a stress test: it was examining the impact of mortgage rate rising from 4.75% to 8%. So concerned about bad debtors was it that it was using a lending multiplier of one.

The operating margin for a builder like Berkeley, for 2009/10, was 17.3% compared with 17.8% the year before. It completed 2,201 houses up on 1,501 but the average price from £395,000 to £263,000. Thus, it built more, cheaper houses. If this were the basis for a price elasticity figure, it would suggest a price elasticity of 1.39.

As the Spanish housing market wallowed in a slump of up to 50%, working with Caja Mediterráneo, Clydesdale and Yorkshire banks sought to lower the asymmetry inherent in a British home-buyer selecting a Spanish dwelling by offering a 'try before you buy' package. This entailed renting a property for between one and seven years.

Indexed Poverty

The distinction between the CPI and RPI index will be significant from now on – well, to pensioners. The CPI is the index used by the BofE when assessing inflation. The CPI does not take into account council tax, mortgage interest payments, buildings insurance and house depreciation. And so does not reflect the same variables. Savings bonds, index-linked securities, wage negotiations and importantly pensions were RPI indexed. The June budget changed that. There was a switch from the RPI to the CPI indexation for public sector, state and private occupational

pensions. Given that the RPI is normally higher, this saves the government and other pension-providers considerable sums. Oddly, as this makes pensions more affordable to companies, this may preserve the final salary schemes for some.

By November, there were a number of bodies concerned about the distorting effect of bail-outs and government fund raising. Graham Beale, CEO of Nationwide, the largest building society and one used as a quasi arm of the state to rescue other failing mutuals, complained about NS&I being ‘way outside the competitive spectrum’. NS&I offered a one-year bond at 3.95% that was considerably above the others on offer over that maturity period. Under such pressure, it was withdrawn early. Moneyfacts reported that bonds of that ilk were available for a very small window (23 days average). In December, its growth bond portfolio was withdrawn from the same reason. In July, it withdrew its RPI linked bonds. It is claimed that too many were seeking to save with NS&I, perhaps again raising the ire of the private sector again. One might speculate that the bonds will return because: the government has a need to raise savings to fund its deficit; it is a means of withdrawing money in a sort of open market operations sense; banks are making little effort to do anything other that support themselves so why worry about their sentiments; and it will give the government the opportunity to switch to the CPI linkage.

Poverty what Poverty?

IFS estimated in May that the Labour party did keep poverty in check. The problem for the pundits is that there is a trend towards greater inequality: if the government slows this growth rate down, poverty will increase, but at a slower rate. The definition of poverty is based on deviation from the mean or median. Using a measure of less than 60% of the median wage after housing costs, 7.8m adults, 3.9m children and 1.8m pensioners are poor. The IFS found that, unambiguously, without their redistributional policies, the rise in inequality between 1997 and 2010 would have been greater.

Cost-Cutting Generation

OECD estimated that between the end of 2007 and July 2009, 15m jobs had been lost across 30 nations. It anticipated that another 10m could go by the end of 2010. As governments begin to consider the budget deficit that the stimulus packages have left, attention turned to job cuts. As pointed out in *Update 09*, central government may be increasing spending, whilst local authorities may be cutting job, in effect,

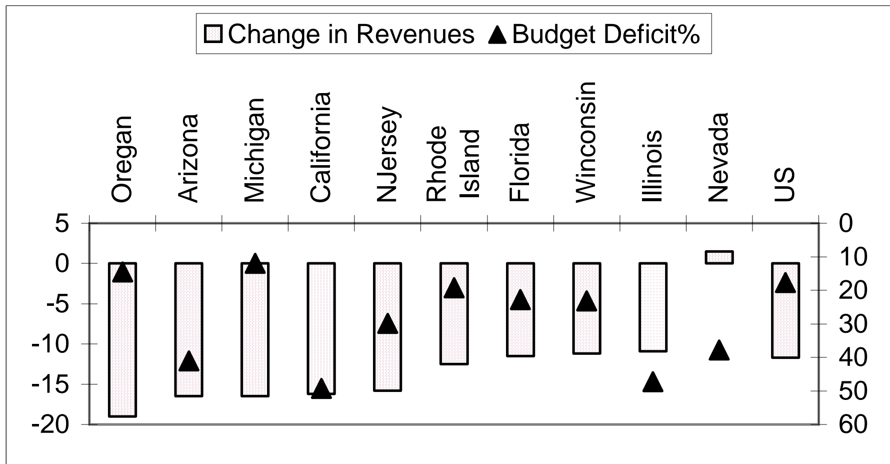
decreasing the stimulus, perhaps making the situation worse. By December, Krugman, the Nobel Prize laureate, was accusing the State governors [who commonly have to honour balance budget requirements of state] of undermining any of the £246bn state-earmarked stimulus packages. The states, with a collective deficit of $162bn for 2010 based on July 2009 estimates, were cutting state programmes by 5.4% ($80bn), and counteracting federal initiatives. Programmes had a variety of periods left to run. What we learned from this is that government expenditure ‘shovel ready projects’ are not that common. Before much of the stimulus spending has been fully injected into the system, the project is cancelled.

By June, of the $862bn stimulus package only $13bn was enacted. That would provide a tax credit to firms hiring unemployed workers. The second boost initiated this year was an extension of 6 month of unemployment benefit. In August, the Senate voted through a mini stimulus of $26bn for the States in difficulties.

In the US, where California is facing the most significant strains, Governor, Schwarzenegger, ordered a garage sale of state property so that Highway Patrol motorcycles could be purchased. Interestingly, in real estate economics, property and other local taxes are posited to influence the location decision. Nevada ran a television and radio campaign pointing out the business tax advantages in that State. Given it has no income or corporate income tax, it may appeal to some. Colorado has also funded a more modest campaign.

With a $19bn hole to fill and because no State budget had been passed, on 1st July, Schwarzenegger ordered the salaries of around 200,000 State employees to be cut to the federal minimum of $7.25/hr.

The table below shows State revenue change between 2009 and 2010 (right-hand scale) plus the budget deficit in the year to Q1 2009. Their combined deficit in 2011 was expected to be $112bn, but by July that estimate had fallen to $83.8bn. The average fall was 12% and the average State deficit was 18%. The methods of reduction are instructive.



The outcome of local indebtedness can be severe. As reported in previous *Updates*, the systems in place in the US can lead to some odd outcomes. As the financial crisis affected regional and local authorities, the balanced budget requirement forced authorise into extreme measures. In Maywood, with a budget shortfall, the city decided to release its entire public sector workforce and outsource the services, such as policing, to the private sector. This was caused, in part, by a loss of insurance over police activities.

US States can be larger than small European countries, but Chinese ones can be larger than the most populous ones. Chinese provinces' deficits were state secrets. However, audited debts of 18 of the 22 autonomous regions, with 16 cities and 36 counties had debts of Rmb2.79trn (£279bn) in 2009. Victor Shih of Northwestern University estimated the true figure could be nearer Rmb11.4trn or 71% of GDP. By July, that 20% of the official estimate of the Rmb7.7trn lent to local government would not be repaid. This is in a growing market. Balancing these books could inflict pain on the whole world. However, the Chinese government was pleasantly surprised by only a 20% rate.

State Mis-Aid

The French Finance Minister, Christine Lagarde, in 2008, brought in a credit insurance support scheme with a cap of €5bn, offering it potentially to those who wanted it. The British support scheme, by contrast was only offered to those not refused it by the private sector providers, somewhat defeating the point. By October

2009, the UK government paid out £81,000 and wrote 70 policies worth £11.9m. A month later, the government signalled that it would not extend the scheme past the end of the year. One might chalk that policy up to ‘could do better’.

The National Audit Office estimated in October that the Rural Payments System had wasted £680m since its introduction in 2005. Errors and penalties concerning EU payments had cost £280m; £43m was lost due to overpayment; and £304m was spend on more administrative staff. An IT system that may soon be obsolete, required £130m in upgrades – could do much better.

Some disquiet was felt in France over the use of tax-cuts to boost trade. A lowering of VAT from 19.6% to 5.5% on restaurant meals resulted in a fall in prices of 1.46% on average in the 185,000 bars and restaurants in the four months following the cut to November. The cut is expected to cost the Treasury €2.4bn over the fiscal year, and possibly only 6,000 of the 40,000 expected new jobs will actually materialise. The restaurant has absorbed the cut.

Scrappage schemes

The success of the car scrappage scheme in the UK was such that, by January, 318,628 vehicle orders were made on this basis. As government’s budget was ¾ exhausted, a quota was introduced for the remaining 81,000 capacity. A consequence of the scrappage scheme was that second-hand car sales suffered. In 2009, 6.8m used cars were sold. This is a decrease of 5.7% over 2008 and only 1% up on the 2000 level. With the end of the car scrappage scheme, the Pre-Budget Report introduced another green scrappage scheme, this time it was for old boilers.

The scappage schemes around the world sought to remove high carbon emitting and low fuel-efficient cars from the roads. Car scrappage scheme in Japan apparently favoured Japanese cars where 50% of models passed the ‘green’ threshold. The test was based on stop-start measures, whereas US and European car are assessed on emissions from a constant 50mph. Clearly, any scheme can be tweaked towards protectionism.

Local Efficiencies

From 1997 to 2009, metropolitan council grants had increased by 61%; unitary councils 53%; London boroughs 41%; counties 37%; and districts 15%. District council areas spend £95/capita, whereas in a unitary authority, the figure was £1,201 and £889 for a county. Perhaps small is beautiful?

Throughout the year new efficiency drives were considered. Central government changed tone in mid-September by admitting that public services needed to be cut, but still committed to maintain front-line services. This requires the more-for-less alchemy that only politicians appear to understand. Before the 'Big Society' initiative, one approach would be to pass more on obligations to the private and third sectors. In North Dorset, leisure services were passed on to Three River Partnerships, a charitable trust that had a tax advantage in that it could avoid VAT and property taxes, and could more easily use volunteers. Richmond and Hambleton district councils share a chief executive and have pooled staff. Bulk purchasing is then more likely and front line services can be maintained whilst cutting staff and other costs.

An approach, associated with the phrase Total Place, appears much like concurrent engineering. This speeds up the design process of a new product, from concept to first unit produced, reducing time to market. The approach seeks to remove the problem of the project moving along a train of departments in sequence, all undertaking their ascribed task. Before, if an insuperable problem emerges, the project returns up the line for a reappraisal. Now, representatives from each department/ stage consider the problem jointly so that design hitches emerge more quickly. A similar approach was emerging in the public sector years before the election. The desire is to cut out duplication and emphasise prevention. One of 13 pilot schemes, featuring Cumbria County Council, works with 6 district councils, a PCT, the police and the national park. The group spent £14,000/capita or £7.1bn in 2008. Birmingham spent £7.3bn. From these figures, a 10% efficiency drive saves around £700,000m.

The quasi market schemes of the Labour government entail measurement or bangs-for-bucks that fosters a focus on addressing part of the picture to which the public entity is tasked, is not consistent with the pooling of funds in this new holistic system. Identify a problem early is crucial. Police work may entail stopping crime and healthcare ameliorating the issue of addiction. Both may be associated with someone falling into petty crime at a relatively early age. This could be associated with persistent absence from school or prolonged unemployment. Poor attendance as school may be associated with a disruptive family life or being in care. This may be associated with dysfunctional parenting. Thus, by investing in parenting classes, some problems that may emerge later on may be reduced. Stephen Hughes of Birmingham City Council estimated that for every £1 of prevention spending it could generate £4 worth of savings later on. Sadly for the number crunchers, the link between buck and bang is not clear. Efficiency saving may actually result in less measurement and monitoring. Interestingly, the Coalition government is now focusing on cost saving rather than quasi market 'efficiency'.

Outsourcing of Government Services

Public sector employment in December 2009 made up 21.1% of the total employment. There were 6.098m public sector employees of which there were: 1.621m NHS; 1.418m educational; 1.208m public administration; and 297,000 police employees. Cuts to the public sector would affect the private sector. It is estimated that there was a £80bn market private sector market for public services. Although there would be some protection of capital spend, infrastructure projects would be put on hold or just cancelled. The impact of this could be severe for many companies. Take Cable and Wireless. It announced, in July, that it was one of the 20 companies invited to the Cabinet Office to hear about the cuts in programmes. In 2009/10, 12% of its income would come from this source and that would all but vanish. Share price fell 17% on this news.

In July, the government mused about changing the informal code on outsourcing to the private sector, public sector jobs. The outsourced jobs should merit the same conditions of service, even to new employees. This latter element was to be dropped. It is estimated that this ‘clause’ added £75m/year to outsourcing contracts of laundry and catering services.

Pensions

A concern for many workers in the public sector is the likely diminution of pension rights. The popular attack of top civil servant pension pots coupled with the collapse of private sector employment and pension schemes meant that their defence was not easy. In 2009, only 65% of local authorities’ pension scheme liabilities were covered so a financial imperative was evident too. Local authority pensions deficit totalled £60bn, with Birmingham leading the way at £1.068bn. The CBI weighed in with a suggestion that the pensions of 5m public servants should be based on building a lump sum that buys an annuity. The CEO of the London Pension Fund Authority appeared to suggest that a shift from a final salary scheme was a win-win. About 75% of workers would be better off under an average pension scheme, partly due to rules related to part time workers and from shifting from 80^{ths} to 60^{ths}. Also, increasing retirement age by 5 years it would reduce the cost to local authorities by 7.4%.

Tax the People More

A 1% increase in basic NI plus an increase higher rate of +2% would increase direct tax. Importantly, although the standard and 40% tax rate remained the same, the

threshold to pay the former was raised and the latter was dropped. Thus, more people fell into the higher (42%) tax rate band. Without changing income tax rates, direct tax-take should increase as a proportion. It is strange that politicians are so reticent to utter the truths of their policies.

Tax the Multinational More

For years, international business textbooks have been discussing the loss of tax revenue as a result of multinationals engaging in internal pricing to avoid tax. For example, GM could charge each factory for use of a patent for a car platform. The 'location' would determine where tax is paid. Obviously, a low tax regime would suit multinationals. So the high profit elements would be located there. If production is in a high tax country, the internal pricing structure could be organised to ensure the high added-value work is domiciled for tax purposes in a low-tax country. For example, DSG declared profits of extended warranties in the Isle of Man. Revenue and Customs challenged this at tribunal and won, so they are now declared in the UK.

The problem for multinationals in the crisis was that elements that were low-profit could still make profits. So a loss-making company could be paying tax on elements, such as car production or distribution, whilst the company as a whole made losses. Strangely, whilst the boot is on the taxman's foot you would have thought that Revenue and Customs would stick the boot in, but no. Practically, they were willing to negotiate tax payments so as not to 'undermine' the company being taxed.

Having set up a holding company in low tax Luxemburg, Vodafone acquired Mannesmann in 2000. This holding company was set up to avoid paying tax. This tax avoidance was challenged. In July, Vodafone agreed to pay £1.25bn over this issue. The UK has lost several HQs to non-CFC signatory countries, such as Ireland. The negotiation approach heralds a sea change in tax policy and could affect another 150 businesses and £2.5bn of tax for the Exchequer. It could be, though, that the immediate revenue stream was more important than extracting the full £2.2bn that Vodafone had put aside to the liability. HQ of ArcelorMittal is Luxemburg. In July 2009, McDonalds announced that their European HQ was to shift from London to Geneva, to take advantage of preferential intellectual property tax laws.

The Structure of the UK Banking Sector

Mervyn King spoke out against the size of banks in October suggesting that the 'casino' element should be separated from the retail or utility. John Kay of the FT

was a strong advocate of this also. His concern was that there was a reinforced moral hazard within which the banks then found themselves. The behaviour of governments meant that banks take on unnecessary risks knowing there were too important to fail. With bailed-out American banks, such as Goldman Sachs making record quarter profits, the bonus culture and the excessive profits appeared to have return quickly. The call to (re)introduce a Glass-Steagall act (1933) was debated.

The arguments against are based on a risk compromise – more growth requires banks to have more freedom to invest and raise capital. By regulating tightly, there will be a lower incentive to invest with less capital and more hurdles to cross before the investment capital is secured. On one level, the issue of unwarranted size undermines a standard economy of scale argument. Normally, size provides economies of scale and assurity of survival. King was at odds with the Chancellor of the Exchequer, Darling. The Bank for International Settlement (BIS) undermined this issue of size providing economies of scale. Reported in July, it was found that there is scant evidence of economies of scale in international banking. Reviewing academic work, it found that below $25bn of assets there may be economies but beyond, where the banks become too unwieldy to manage, diseconomies set in. BIS argued that banks exploited the moral hazard and grew too large *deliberately*.

State Aid

At the end of October, ING was forced to dispose of significant assets. This follows on from two German bank disposals mentioned in *Update 09* Commerzbank and WestLB were forced to reduce their sizes by 50% and 47% by Neelie Kroes, EC Competition Commissioner. The policy was that if a bank was in receipt of state aid, it was granted an unfair advantage and, so that it would not be as powerful, this should be redressed by restructuring (enfeebling) the supported company. Moody's suggested that lower support would lead to a lower credit rating. This is illustrated by Fitch, which, on 21st June, downgraded BNP Paribus from AA to AA–. This was due to deteriorating asset quality. However, the rating was partially based on the presumption that it is a large bank, too important to let fail: the French government would bail it out. In other words, the bank rating is based implicitly on that of the French government's. The government support for banks could increase their credit rating by 4 notches. Interestingly, less of a moral hazard, banks are reliant on their credit rating for access to capital at reasonable rates. If they are not creditworthy, the rates become punitive and the sums become modest. Comparing the difference between the debt of supported and unsupported banks, the implicit guarantees that the BofE provided UK banks was estimated to be worth £50bn/ year for 2007-2009, with the top 5 receiving 90% of the benefit.

This has been the era of the bail-out. The justification of industrial policy with an ailing duck is generally to preserve jobs. A two-year study by Oxera and sponsored by the EU, estimated that €279.6bn or 2.2% of GDP was spent on state aid in 2008. Crisis measures made up the majority of the €212.1bn, with the UK contributing ⅓. State aid in 2007 was only €66.5bn (UK, 0.52%). The aid did not restrain distressed firms from shedding large numbers of jobs as intended. Considering 1,300 large companies, the consultancy found that job loss was linked to earlier speed of expansion, degree of indebtedness and operating in a depressed area. Of the 'unaided' ones, 77% subsequently existed either as part of another company or as a going concern.

The consequences of such a bail-out can be illustrated with shipping. As discussed in *Update 09*, too many shipping lines ordered too much additional tonnage so that there would be a glut during a severe downturn. The consequences of that emerged this year. CMA CGM, the French cargo shipping line, began talks with the government in search of additional funding. Hapag-Lloyd of Germany, Zim of Israel, and Chile's CSAV and CCNI were also in talks or had restructured. The CEO of Maersk, Nils Andersen, in November, criticised governments for this practice, arguing that treating one ailing company like this can inflict harm on otherwise healthy companies. In effect, he was suggesting that one way of removing excess capacity is to let ailing companies fail. This is key. Brussels' antitrust unit also was concerned. The Commission indicated that any coordinated reduction in capacity constituted a 'potential hardcore antitrust infringement.' The irony cannot be lost on consumers. Very large companies were bailed out (RBS, Lloyds, GM, Chryslers, Renault, Peugeot, Opel). Some were forced to restructure due to failure; others by Neelie Kroes, but, as with French car producers, little altered.

In a deep recession, one would anticipate that there would be a return to tit-for-tat erection of trade barriers. Although these are not as widespread as expected (see *Financial Update 10*), one could argue that this has occurred. New forms of protectionism, such as public procurement and restricting export licenses, were still practiced. However, Simon Evenett of St. Gallen University suggested that indeed there was an epidemic of protectionism. This sort, though, was based on bail-outs of car companies and banks. He estimated 496 policy measures had been initiated since November 2008: only 99 were the standard new forms, such as antidumping duties.

A standard criticism of trade protectionism is that it induces lower trade, higher prices and lower income. In effect, with increased state aid and the consequent government budget retrenchment, the global economy was experiencing the same as a trade war. Raising taxes rather than reduced exports and lowers demand. Also,

subsidizing the losses of domestic producers, through higher VAT, raises the prices of home goods and services.

In September, RBS was considering raising £3bn in shares. The aim would be to reduce, but it could not eliminate, its need for the Government's Asset Protection Scheme (APS). RBS was forced to issue £19bn of '*B*' shares (non-voting) in exchange for coving £325bn of toxic assets. This would increase the degree of state ownership up to 85%. Lloyds also tried avoid the scheme but were advised by the FSA that they needed to raise more capital to pass a stress test. In October, RBS was considering selling-off all 318 RBS branches in England and Wales to appease Neelie Kroes.

Structure

In November, the UK banking world changed. Under pressure from Europe to dispose of a significant proportion of assets, the Chancellor announced, over 1st–4th of November, what Lloyds and RBS would sell off:

RBS	Lloyds
318 RBS branches in E&W Nat West branches in Scotland RBS Insurance Direct Line, Churchill, Green Flag Global Merchant Services RBS Sempra Commodities Williams & Glyns (only a brand name)	600 branches inc TSB and C&G Intelligent Finance

From the tables below, the problematic structure that resulted from the crisis structure is clear. The CML show that in 2007 the top six banks offered 60% of new mortgage lending. By 2009, the top six offered 90%. Neelie Kroes, the EC Commissioner looked at the market dominance of Lloyds and ordered that a substantial share in these markets. Also, she wanted a reduction of 2% points of RBS's retail banking market share.

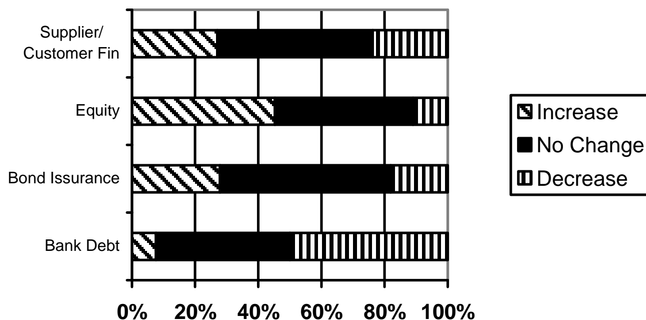
	Mortgage market share%	Retail market share%	Branches 2008
RBS	6.6	6.9	2279
Barclays	6.9	7.4	1724
HSBC	4.6	?	1444
Lloyds	28.5	18.2	2982
Nationwide	10.6	10.7	900
Santander	13.1	10.1	1328

Source: Santander

Lloyds-HBOS market share 2008 Dec

	Lloyds	HBOS	Market Position UK
Current Account	17%	14	1st
Mortgages	11	19	1st
Credit cards	12	12	1st
SME	18	4	2nd

The structure of the banking sector for the SME market also was worrisome. With RBS, HSBC and Barclays, Lloyds controlling 92% of the market, Structure-Conduct-Performance (SCP) suggests the customer will not be well served. The CBI, in November, reported that sources of credit were not supplying what was needed for SMEs and new providers were needed. A possible substitute was a regional bank network. As a last resort banks are avoided completely. Large firms (employing over a million workers) have altered their funding strategies. Half had moved away from debt and 43% have moved to equity.



Bankers' Old Tricks

By the end of 2009 banks were up to their old tricks. Reports in newspapers became more common about the variable interest rate on ISAs had drifted so low that it made more sense for a tax-payer not to use one. In other words, relying on customer indolence to earn profit, the banks were taking even more than the tax wrapper off the investor. From an economist's point of view the banks could move close to the point of indifference between an ISA and non-ISA savings account but to go beyond there is just blatant exploitation.

Since the launch of ISAs in 1999 to 2010 £158bn had been invested. By March, the rate of return was 0.46%. Consumer Focus launched, in April, a super-complaint relating to the lethargy in transferring accounts with higher rates: a third of the transfers took more than five weeks according to their survey. The British Bankers Assoc. reported net deposits in April were a tenth of those of the previous 10-month averages, however the saving ratio was still 6.9% in Q1 with £1.1trn tucked away.

Again, arrangement fees and other hidden charges were the bane of the small business. At 1.75%, this arrangement fee could add significantly to overheads. Finding a loan at the beginning of 2010 was hard. The British Chambers of Commerce pointed the finger at the lack of competition to explain the restricted funding and the Federation of Small Business highlighted the misrepresentation of the true loan availability - what is on offer is not what could be taken up. An IoD survey revealed in July that, in the first half of 2010, ⅓ of SME loan applicants were turned down by a bank. Successful ones were asked to supply significant collateral, even when ¾ of the loan value is underwritten by the government. Moreover, 37% were asked for more collateral.

By contrast the British Bankers Association reported that commercial banks had lent £523m in more than 10,000 new loans in May, £100m less than the year before, but at least similar to April's numbers. Also, in their defence, Barclays reported its lending rates per application to government and lenders in July. To large borrowers, it found its lending rates to be 90-100%. For small borrowers (turnover > £5m) the rate was around 80%, up from 70% in mid 2009. Its not lending but applications that were problematic, at odds with the IoD survey above.

Age restrictions were being applied in August 2009 that meant those that had retired could not access new deals. Previously, there was no age restriction, but with the dash for quality, those over-65 were left with few options. Scottish Widows estimated that 1.35m retired people had mortgages with an average of £50,100 outstanding. This had increased by £8,000 over the year. Indeed, credit card debts

were also mounting, at an average for retired folk of £7,350, up from £5,930. In February, reports of banks using even more information about prospective mortgagees' disposable income emerged. Yorkshire Building Society was one of a number of providers, in effect, using a stress test: it was examining the impact of mortgage rate rising from 4.75% to 8%. So concerned was it about bad debtors that it was using a lending multiple of one. By contrast, the 100% mortgage for first time buyers returned in September with the Mansfield. Absent for 18 months, the loan facility was offered to South Yorkshire Housing Association clients.

In May, following the Skipton in 2009, Lloyds removed the restrictions on the rate mortgagees paid after their discount offers ended. This could raise their rate by 1.5%. Concurrently, following a Lloyds' policy change in April, Northern Rock stopped accepting dividends, inheritances, regular overpayments, remuneration bonuses for interest only mortgages.

Despite severe restrictions it is strange to find that, of new mortgages between 2007 and Q1 2010, 47.6% were self-certified mortgages (liar loans). The FSA found that 30% were interest rate only and 46% of households had insufficient income to meet their monthly commitments. This strikes one as inconsistent with credit tightening and reckless. In the US, credit-scoring using the Fair Isaac system, FICO, tightened over the last year. However, better screening is leading to a far lower mortgage distress rate. Interestingly, partly because of a more rigorous application of standards, in July mortgage rates hit a 50-year low for an average 30-year term of 4.57% and yet applications were falling, not rising. As reported in *Update 08*, estimating default rates in the US became extremely unreliable when sub-prime borrowers opted to default on the mortgage rather than other loans and credit card debts. This problem continued drifting up the quality hierarchy in 2010 as more well-heeled borrowers fell in to long term negative equity and lost their jobs. The 'market' even provided support for this. A company, named *You Walk Away*, for a fee, assists in the process of defaulting and walking away from the mortgage. This will have implications for US and international banks with mortgage debts on their books. Yet again, they will not be able to value exposure to mortgage debt and so, being risk-averse, lend out less to its customers.

Government Protection

Meanwhile, both RBS and Lloyds continued to negotiate smaller and smaller involvement in the Asset Protection Scheme. Concurrently, the government gave Lloyds and RBS an additional £39.4bn. Lloyds avoided APS but promised a record rights issue of £13.5bn plus selling off brands to take the total new money to £21bn core tier one capital. The government's share of this would be £5.9bn. The exit fee

from the APS was £2.5bn. RBS received £25.5bn plus another £8bn in February. Twice that which Citi bank had received from the US government, RBS's state funding rose to £53.5bn. The state then controlled 84% of RBS.

Announcing a pre-tax loss of £2.2bn in November RBS parked £242.8bn in the APS and agreed to be liable for the first £60bn. RBS will pay the UK government £700m a year to be in the scheme and £2.5bn to exit, if and when that happens.

Change to the Market Structure

Bains, a business consultancy, suggested in August 2009 that the pre-2007 return on equity of 24% on retail banking would not return. To combat rising costs and falling profitability, 30% of retail branches needed to be closed. In April, it was reported that indeed banks were shutting branches. Leaving 11,220, and excluding Lloyds, 434 had been shut in 3 years. Barclays had closed 316 and HSBC 107 since 2007. This offered the Post Office with 11,200 branches, with an opportunity to gear up to offer banking services in March with a current account, loans and first time buyer mortgages. Government proposals for the PO included accessing some accounts through the Post Office from other banks and, interestingly, credit unions. With 850,000 members, credit unions serve the unbanked. Strangely, one of these banks was Halifax.

During the year, the Co-op merged with the Britannia Building Society. Both provided deposit and banking services. After closing duplicates with the old Britannia, the Co-op Bank would have 300 branches. However, with 5,000 Co-op retail shops, like Tesco, there is scope to increase its bank network further, offering the tantalising prospect of a national rival to the established banks, in a way that Abbey and Halifax did not. Indeed, the Co-op is not the only alternative provider. Despite the call to create alternative local banks outlined in *Update 09* only one, Essex Country Council, of the four local authorities went ahead by January. Lending an average of £33,000 to 8 borrowers, the outcome was disappointing. This is a fine example of policy announcements not coming to fruition. When it acquired its banking licence in March and opened its doors in July, Metro Bank became the first new high street bank for 100 years.

Darling's suspension of competition law to deal with an immediate and potentially catastrophic situation was a private sector solution to a crisis. The National Audit Office estimated in December that, despite the £850bn price tag for support of the banks, including share purchases, guarantees insurance and loans, it was the right thing to do. However, given that reliance of the remaining large providers left the country a hostage to LIBOR fortunes, a broader base would be wise. Also, with a

poor structure in the SCP sense, banks were too large for the customer or the state to accept.

The unpicking of the greater HBOS-Lloyds merger by Neelie Kroes is significant and an indicator of how a European regulation supersedes a national one. However, the forced restructuring of the nationalized banks were not the only changes in the market. Many building societies were also force to seek a partner or lose independence, particularly given their exposure to weak property markets. Also, the possibility of entering the banking market without the legacy of large debts caught the attention of new providers. A summary of the changes is below:

Change in the banking structure

Lost Independence	Comment	Found
Abbey, Alliance and Leicester, Bradford and Bingley	AB and rebadged as Bank of Santander	Essex County Council (with the Bank of Santander)
	Divested RBS AB Bank of Santander	
HBOS	AB Lloyds	Divested Lloyds
Derbyshire Cheshire (Catholic) Dunfermline.	AB Nationwide Building Society	Virgin
Britannia	MW Co-operative Financial Services	Metro
Barnsley, Chelsea	AB The Yorkshire Building Society	
Scarborough, Chesham	AB Skipton Building Society	
Stroud	AB Coventry	
Northern Rock	Nationalised	Privatised Northern Rock
Kent Reliance	JC Flowers (invest)	

AB: Acquired by; MW: Merged with

In March, the RBS branch sell-off hit a major snag. The units out-placed by RBS worth £24bn would require £2bn in capital to support the loan book, and it would be dependent on emergency funding from the government to cover a further £3bn to replace the Special Liquidity Scheme funding. Originally, Santander was barred from being a bidder, but it was one of the few institutions large enough to support such a risk without government support. By April, Blackstone (private equity) and the Wellcome Trust (charity) teamed up to bid, along with Virgin Money, backed by Wilbur Ross; BBVA (a Spanish bank); Santander, owner of Abbey, Bradford and Bingley, and Alliance and Leicester; and National Australian Bank (NAB) owner of Yorkshire Bank and Clydesdale Bank were interested in 318 RBS branches. Bids were thought to be in the range £1.5-2bn. At the end, only Santander remained as a

bidder, and it reduced its offer from £2bn to £1.65 in August 2010 to reflect the debts it would inherit. BBVA became interested in NAB's UK network as a sort of booby-prize.

Lloyds sold its estate agent subsidiary LSL in October for £1. This adds 218 outlets, based on Halifax Estate Agents, to the existing 357 branches based on Your Move. The European Competition Commissioner had reiterated her concern about market dominance two weeks before.

The 11th largest building society but with only two branches, the Kent Reliance, received an offer from JC Flower of £50m for a 49% stake in its assets. Looking for a banking licence in the UK, JCF bid for Northern Rock. The Kent may offer a licence but no real branch network, leading to speculation that other injections in to building societies could follow. As a mutual, the Kent has no shares to sell, so the intention is to form a new company through a new structure called an Industrial and Provident Society.

Interestingly, JC Flower was also investing €1bn in August in another mutual, Banca Cívica, which failed the stress test two weeks before and considering injecting €300-400m in the Irish Building Soc., EBS. Between them, Santander and JC Flower were raising their profiles in Europe.

By July, RBS had sold more than 20 non-core businesses, driven, in part, by the EC directive. One such disposal entailed selling its Indian operation to HSBC. Strangely, RBS was willing to absorb 90% of the losses from the unit for 2 years that could have meant that it paid HSBC to take it off its hands.

Commercial Property

According to De Montfort University, £30.4bn of commercial loans was in trouble in H1 2009: £18.6bn were in breach of covenant and £11.8bn were in default. An additional £16bn was refinanced or rolled over. The value of outstanding debt secured on UK commercial property was £224.1bn, which was £1.4bn below the record value of the previous half-year. The crisis in commercial property led, in 2008, to a reduction of 1.2m m^2 of commercial property, to 574.9m m^2. The explanation, suggested by NB Real Estate, includes demolition of existing infrastructure and a sluggish rate of new premise construction. Of the three categories, industrial (factory) space fell by 4.5m m^2, whereas retail grew by 960,000 m^2 and office (and warehouse) by 1.3m m^2. The contraction was the first since government records began in 1998.

Booz & company reported in December that £110bn of working capital was tied up in inventory and other parts of the balance sheet by British companies, equivalent to 10% of revenues. Their survey covered 212 companies with revenues of £1.2trn. In keeping with this, Begbis-Traynor found that 4,021 retailers were facing cash problems in November. In April, Trevor Woods Assocs. reported that 20% of high profile retailers that rent premises, such as Focus, were either in administration or subject to a voluntary arrangement. Indeed, out of the top 50, 40% had disappeared since 2002.

Stress Test I

In November, a BofE consultative document proposed using a variety of specific capital ratios to assess stability that echo an earlier era of monetary policy entailing reserve ratio management. Concurrently, the Nationwide was in talks with the regulators about another financial instrument for building societies. In June 09, the FSA allowed the West Bromwich to engage in the first building society debt-for-equity swap using Profit-Participating Deferred Shares. PPDS acts like a bond in that it has a coupon but the coupon varies with profitability. The Nationwide wants something like a CoCo: debt, which converts into a PPDS. CoCos are viewed as a potential resolution to excessive bank debt funding.

Regulators across the world, including the FSA became intensely interested in liquidity and the issue of clarify of reporting. The issue of large banks proving to be contagious, systemically, compelled the FSA to propose higher standards of self-reflection.

Banks were to be expected to run stress tests on their position – a simple ratio will not do. They then estimate the amount of cash and gilts they hold. If the FSA required banks to hold 60% of their worst case needs, the FSA estimated that it could require banks to hold an additional £110bn of gilts, reducing returns by £2.6bn. Credit Suisse suggested that this would triple cash holdings to 15% from 5% held in 2008. This would reduce returns by up to £9.2bn. A Basel Committee estimated a similar increase (11.5%) for world banks. One way of reducing this exposure is not to hold risky assets or rely on short term funding.

Liquidity rules and the level of detailed reporting as proposed by the FSA in October varied with the type of institution. Laid out below is the division. Larger, systemically more important institutions had a greater duty to report details that could be used to assess any contagious potential. Liquidity requirements were to be based on the results.

	Model	Number Based in UK
Standard liquidity rules and reporting	Banks	113
	Building Societies	9
	Large Investment firms	97
Simplified liquidity rules and reporting	Smaller Building Societies	90
Branches of Overseas Banks*		197

*unless more stringent rules applied to parent

The FSA in a report issued in June found that auditors lacked scepticism in their audits of some financial companies. Too often the auditors were focused on gathering information to support assertions rather than exercising professional scepticism. This is one view. The House of Commons Treasury Committee recommended, in 2009, that they should not earn additional fees from non-auditing. About half of their earnings in 2009 were from audit fees. Indeed, following an audit of auditors by the Financial Reporting Council, it was revealed in July that some auditors were signing off work before it was completed in 2009/10.

Lord Turner in early September 09 suggested that banks should pre-plan their own demise. Clarity of legal structure was desirable to manage winding-up as well as for regulation and tax obligations. Proposed regulations over living wills, discussed in December by the Basel Committee, were criticised by Citi and Deutsche Bank representatives over this issue saying that the requirement to hold more local capital and have local break-up plans could harm the global financial system. Interestingly, Brazil compels subsidiaries of banks owned overseas to hold their own capital. This meant that Brazil was, to a great extent, immune to the banking crisis in the West.

For regulators trying to assess the extent of distress, the structure of business can be very unhelpful. The numbers of companies within a group can be enormous. RBS had 1559 companies under its umbrella and Lloyds 769. Of these, 238 and 125 were in tax havens, respectively. HSBC, the most dispersed of the UK big four, had 2,008 companies, of which 529 were in tax havens.

Bank Regulation

The regulation of the financial systems by both US and UK theatres changed again in mid 2010. In the UK, the Coalition decided to remove the FSA and empower the BofE. The BofE would be responsible for monetary policy and both macro-supervision of the system (bubbles) and micro-supervision (bank oversight). As argued in *Update 08*, it is possible that the Northern Rock debacle came about

because of the division of powers between the FSA, the Treasury and the BofE: the FSA believed too strongly in the financial self-regulation of institutions that were inherently risk-seeking. Interestingly, the Coalition set up a Banking Commission to consider systemic risk factors, the issue of banks being a mixture of utility and casino, and whether they should be separate.

Of the same period and direction, in the US the Senate approved Obama's Finance Regulation bill in July. It covered:

- Consumer Protection Agency to prevent abusive practices by lenders, such as lending to those unable to repay from the outset;
- Council of Regulators would oversee macro-regulatory matters (bubbles). It would bring together the heads of the various financial regulators under the FED;
- Resolution Authority would be able to seize and wind up financial firms like Citibank. It is hoped that this would address the so-called 'too big to fail' issue. Institutions would be required to write a living will;
- OTC $600bn derivatives market is forced through clearing houses;
- Large banks would be required to increase the amount of equity capital;
- Banks would be banned from proprietary trading activities (casino activities cannot involve the bank's money);
- Banks investments in hedge fund is limited to 3% of their capital.

Banks Continue to Fail

The Dutch privately owned bank, DSB, was taken into state ownership in mid-October. In the week before, there was a run on the bank. The finance minister, Wouter Bos, suggested it was not related to the credit crisis. Interestingly, the owner of the bank, Dirk Scheringa, accused the government of leaking suggestions that is was bankrupt. Perhaps through postings on Twitter, or a complaint by a pressure group about the bank's lending practices with expensive insurance suggested that it would be better if the bank collapsed, there was a run on the bank.

CIT filed for bankruptcy in November. With pre-bankruptcy assets of $71bn, it is in between GM and Chrysler as one of the largest failures in US corporate history.

Austria nationalised Hypo Group Alpe Adria (HGAA) in December. With activities in 12 other countries, it has a huge exposure to the Balkans. Croatia, the Ukraine and Bulgarian operations lost €520m in 2008. Although the Austrian government wanted it to fail, it found that the state of Carinthia was exposed to €18bn in liabilities so it was forced to intervene. Other Austrian banks with Central and Eastern European exposure totalling €200bn offered a further €500m.

Abusive Lending Practices

One would expect that, to combat the excesses of banks, a better-informed client base would not be exploited. However, Prof. Lauren Willis wrote in the Iowa Law Review that the study time needed to be informed about financial products is well-beyond the reach of most consumers. Worse, even a training programme is inadequate, as the product structures shift like sands in the desert. Prof. Willis finds that education does not appear to make much difference to making good decisions.

Derivatives

Interestingly, one of the groups most in need of the complex products, such as derivatives, is the multinational producer. Hedging against currency or commodity movements can be essential. Airlines need to shift the risk of oil price rises so they commonly hedge against adverse price movements.

With some doubt hanging over futures markets, a logical but possibly less efficient means of hedging emerged. Funds are interested in buying the physical commodities. Rather than buying the rights to something in the future, pension funds and banks, such as Morgan Stanley, are buying materials and hoarding them in warehouses or super-tankers. At the end of October, the London shipbroker, Gibson, estimated that 8% of very large crude/ gasoil carriers (42) were storing not transporting. As the price of chartering was $28,000/day the bet must be that the revenue lost will be more than offset by higher petrol prices later. A further 71 of the largest product tankers were also used as storage facilities; in total 129 were being used. By December, Texan oil storage facilities were full. The pension fund of the Employees Retirement Association in San Bernardino County, California, put $30m into a hedge fund that directly raises cattle, rather than invests in companies that rears livestock. Vermillion Asset Management stores corn and soya as well as holding stockpiles of aluminium. Red Kite trades and stores metals in warehouses.

Quasi Market Misallocations

The outcomes of years of implementing a quasi market in health emerged during the year and then the Coalition government appeared to begin to dismantle it. As reported in previous *Updates*, targets may encourage inappropriate allocation of time. A government report, commissioned by Lord Darzi, undertaken by Joint Commission International and unearthed through the Freedom of Information Act, found the reliance on target-driven delivery produces predictable secrecy and denial.

The report finds that managers are unlikely to admit weaknesses and it is difficult to see how poor hospitals would improve. It identifies a culture of fear in the NHS. The gap between the self-assessment reports and external reviews can be alarming. Examples of significant gaps include the hospital with the worst death rates in the country rating itself as 'good'.

Three reports commissioned by the government concerning the NHS and unearthed by the Sunday Times (7th March) indicate the quasi market in health was producing disturbing trends. Conclusions include a deprofessionalisation of the process; adhering to contractual arrangements rather than volitional work; a disturbing rift between doctors and managers; and most damning of all is the absence of patient care and meeting expectations of families. Hospitals, such as Maidstone and Tunbridge Wells, ignored basic hygiene to cram in patients to meet targets, such as waiting times. In 2005-6 M&TW were subject to an outbreak of Clostridium Difficile that was responsible for 269 deaths. The Institute for Healthcare Improvement, Joint Commission International, and the Rand Corporation reports were not available for the Mid Stafford report.

Following the president of the College of Emergency Medicine, John Heyworth, in March warning that the 4 hour A&E target was putting the health and safety of patients at risk, a spokesman for the Dept. of Health responded that patient care should always take priority over administrative targets where a doctor believes that is necessary. The logic of this statement is based on a manager not having seniority over a doctor, but in the QM world, doctors should be managed. Indeed, Lord Crisp, in an interview with the Sunday Telegraph, pointed out that the NHS could learn from Africa. He suggested that there was a paradox in paying for highly specialised training and then requiring surgeons to do routine work. This problem has been mentioned in earlier *Updates*. But management priorities should take precedence: in this model, doctors cannot be trusted.

When asked whether they would be unhappy for a friend or relative to be admitted to their hospital, no staff of the Papworth Hospital and the Royal Marsden, whereas only 41% at the Mid Staffs were happy in those circumstances. The survey, run by the King's Fund, of 300-400 NHS staff at all NHT trusts revealed, in March, that there was a link between low scores and other poor indicators, such as death rates. However, Sunderland and Tameside Hospitals, flagship Foundation Trusts, also had low scores; around 18-20% of staff were unhappy.

It was reported in March by the NHS Ambulance Trusts, as in *Update 09*, that hospital managers across the country were allowing seriously-ill patients to be kept waiting in ambulances to avoid falling foul of the four hour rule for treatment in

A&E. In the first three quarters of 2009 in England, 'dead time', when ambulances are forced to be idle, was 284,000 hrs. This is equivalent to about 100 additional ambulance shifts. Independent but not unrelated to this, Primary Care Trusts (PCTs), who fund hospitals, were paying ambulance services £38 for every casualty kept out of A&E. As far as the PCT was concerned, it is cheaper to resolve the problem by phone or at a GP's out-of-hours service than letting it get to hospital. Indeed, South Central Ambulance service, which serves Oxfordshire, Berks, Hampshire and Bucks, offered its crews entry into a weekly cash prize draw of £200 each time a patient was redirected. As this might put patient wellbeing in to question, when challenged, management scrapped the scheme.

One source of income for hospitals, car park charges, was to be pared-back as Andy Burnham, the Health Secretary committed to allowing family and friends of in-patients to use visitor passes. The income generated, £2m, would be sorely missed as the NHS is committed to reducing expenditure by £20bn.

Economies of Scale

Following concerns about unexpectedly high death rates at Bristol Royal Infirmary, the Dept. of Health imposed a new rule on experience. A surgical unit must contain at least four surgeons and undertake at least 400 operations a year. This is to ensure that specialists were not spread too thinly. The downside of this is that half the surgical units will close.

Competition in the NHS

Andy Burnham, the Health Secretary, in September, announced that GP catchment areas would be abolished within the year and patients would be allowed to choose their family doctor. He expected that, through choice and competition, it will 'drive up standards'. It is anticipated this change will cause problems for the practices located in rural and suburban areas as the fit employed opt for a doctor close to where they work, denuding rural practices of the low cost, healthy patients.

Andy Burnham, announced in December that 10% of hospital's income would be based on patient satisfaction. The plans for the NHS up until 2015 also provide for job guarantees in exchange for wage restraint. Some of these points became embedded in Coalition policy in July.

Not stated as a case but still one of note, in September 2009, Andy Burnham changed policy on competition stating that the NHS is the preferred provider. As a result, PCTs may be breaching competition rules. Great Yarmouth and Waveney

PCT were taking only NHS bids, discriminating against other providers. This problem of seeking best value will emerge with the new Coalition healthcare reforms.

Labour Issues

Income Data Services (IDS) found that NHS CEOs in 2009 earned on average £148,000 with Foundation Trusts CEOs receiving 10,000 more. Remuneration for CEOs had risen by 6.1% and 7.8% respectively (6.9% average) for 2008/9; 13.7% for the last two years; and 100% in real terms since 1999. By contrast, average nurses' pay rose by 60% over the period. The hierarchy in the NHS means that a PCT CEO earned £138,000. The turnover of non-Foundation Trusts directors is double that of Foundation Trusts. Also, PCTs find it difficult to attract directors of quality.

Employment in the NHS grew by 30% from 1999. Of this rise, GPs grew by ⅓, Junior Doctors by ⅔ and nursing staff by ¼ to 375,500. The number of managers though rose by 84% to 44,660. Running a campaign against market reforms, the BMA found similar figured. From 1995 the number of senior managers increased by 91% whilst doctors rose by 35%. Since 2003, £220m was 'wasted' on market driven healthcare policies. For example, only 85% of operations outsourced were carrier out. The market was skewed in favour of chosen outcomes. The new GP-led polycentres, which the NHS regions must have, were paid 3 times as much per patient as traditional practices. Overall, the chair of BMA, Dr Meldrum stated: "we want an NHS with patients, not profits at its heart". Perhaps this is a temporary suspension of hostilities.

Number of Hospital Beds

Reform reported in March that more hospital beds should close to save money. In London, the north east and north west it recommended a quarter of beds could go. But this is an acceleration of a trend. Today, there are around 160,000 hospital beds; in 1987 there were almost 90% more. As technological advances, treatments improve and bed management is advanced, patients spend less time in hospital. There were very few day-case operations 30 years ago. Cataract surgery once required a week's stay. Today, like 200 other operations, it can be done in a day.

In February, reports about the NHS were published. The Nuffield Trust reported that amongst England, Wales, Scotland and Northern Ireland, NHS expenditure/ head was lower in England but more services were delivered. The report points to payment-by-result and naming-and-shaming in England as key variables. Moreover,

purchaser-provider split was abolished in Scotland 2004 and Wales in 2009. Indeed, it was concluded that in Scotland the provision had been 'captured by doctors and nurses'. Also an LSE leading academic on quasi markets, Carol Propper, reported that, using a narrow range of measures, hospitals with local rivals perform better, and that hospital management is better if managers have some clinical training. This is partly because payment-by-results may encourage hospitals to provide better care and attract patients and, with more rivals, there more job opportunities for good managers/ staff – reputation and reward for excellence produces results. Academics find evidence of working QM.

PCTs

Civitas, a pro-market consultancy, reported in March that market forces in the NHS had failed to bring the anticipated benefits. The NHS was in a 'lose-lose' situation. It pays the extra costs of tendering, of excess capacity, and of the infrastructure needed to run competition and choice, but because ministers and Whitehall still exercise too much control, does not reap the full benefits. There is, though, evidence of better access to care for patients; reduced waiting times; increased efficiency; improved financial management; and improvements in some aspects of quality of care. It criticised PCTs for poor commissioning and the failure to outsource work to the private sector. In an alarmist tone, the chair of the Commons Health Select Committee warned in April that the PCTs, in general, perform woefully when it comes to commissioning. Absorbing possibly 14% of the NHS management and administration budget, they lack the clinical knowledge and other skills to suitably oversee or monitor hospitals. Indeed, Kevin Barron, the chair, suggested scrapping the purchaser-provider split in England. After all, it has gone from Wales and Scotland.

The PCTs could not control the expenditure of GPs either. New contracts and alternative provider medical services have allowed PCTs to commission new surgeries and other medical services from other providers. This has meant contracts could be awarded to polyclinic owners that control more than one clinic. In April, the Sunday Times revealed that 5 doctors earned more than £300,000.

About 80% of 370 doctors surveyed by the Dept. of Health reported that what would have to be provided by community services in replacing hospital provision once '£20bn of efficiencies' are located was believed to be inadequate. The results, reported in 'Pulse' before the election, found that half saw services were already being withdrawn and a further ⅓ of GP said they were planned.

Pharmaceuticals

One perennial concern about the pharmaceuticals industry is the way firms interact with research into medicines and attempt, once they are produced, to influence their prescription. In Q2 2009, Merck paid speaker fees of over $3m to over 1,000 doctors in the US to those invited to their medical fora (an average of $1,548). Eli Lilly paid $22m to 3,300 doctors. The barring of influencing doctors' prescriptions does not extend to governments. In April, the European Court of Justice ruled that is was legal to provide incentives to NHS doctors to prescribe cheaper medicines. The Association of British Pharmaceutical Industry argued that the government should be subject to the same restriction as on its members; no one should offer financial incentives to doctors to sway their judgement of which drugs to prescribe.

It was reported in *Update 07* that, since 2002, about a dozen risk-sharing schemes between pharmaceutical companies and the NHS have existed. Following a finding by NICE's of poor value for money, the company offers to underwrite the cost of their drug where the treatments prove unsuccessful, so demonstrating NICE was wrong. This radical proposal shifted the burden of risk for judging success off NICE/ NHS and on to the pharmaceutical company. However, the process does not work that well. After rejecting Avonex, Betafferon, Rebif and Copaxone, as not offering value for money in 2002, companies discounted them by between £5,800 and £8,000 with the proviso that there was a review of price when they were shown to be effective. It took until 2005 for the multiple sclerosis treatments to have been prescribed to 5,500 patients and another 2 years for the results to complete the evaluation. The outcomes in June, from the £8,000/year course of treatment, reported in the BMJ by Prof. McCabe of Leeds University, were judged to be poor. Yet the price was not cut as agreed as the monitoring group wanted a longer study period. The vested interests of the monitoring group could explain this. The manufacturers formed part of the group. If the treatment were halted two years in, it would have saved the NHS £250m.

A group funded by drugs companies selling OTC medicines and supported by doctors, nurses and health charities found that common ailments account for nearly one fifth of GPs' workload. Over 50m consultations for simple ailments about the common cold, back pain, dermatitis, nasal congestion and coughs are scheduled each year, costing the NHS almost £2bn a year. It is alleged that consolations occur because seeing the doctor is free and conveniet or just a friendly face, rather than a need.

A Costly Bed

In an effort to free up beds, it is alleged that patients were being discharged early. It is suggested by the Coalition government that the increase in emergency readmissions in England between 1998-99 and 2007-08, from 359,719 (8% of admissions) to 546,354 (10.5%) was because of the reduction in number of hospital beds and the urge to hit targets. In June, it was announced that hospitals in England will be paid for initial treatment but not paid again if a patient is brought back within 30 days of being discharged with a related problem. Hospitals would have the responsibility of looking after patients' health and well-being for that period. This replaced the existing system where PCT and GPs are responsible for aftercare.

Dr Jennifer Dixon of the Nuffield Trust and Dr. John Heyworth of the College of Emergency Medicine pronounced the rise in hospital emergency admissions is 'unsustainable'. According to the Nuffield Trust, the number unplanned admissions a year is 4.9m. This figure is 12% larger than in 2004-05 and now accounts for ⅓ of admissions, adding an extra £330m/ year to costs. An aging population, among whom emergency admissions are more likely and financial incentives in the NHS, which encourage admissions and quicker turn around, are explanations.

Targeting Aims

In July, the Coalition government announced more than 30 'quality measures' replacing targets for three areas of care. Stroke, dementia and blood clot aims are 'not enforced by central government'. Instead, the Coalition leaves it to doctors to get the health service there. Another 150 sets of standards should follow. Currently, it is not clear what this means. Lansley later announced that the requirement (target) for patients to see their GP within 48 hours, the 4 hours aim when attending A&E, and the requirement for a hospital to see a patient within 18 weeks of referral were all to be dropped but data is still to be collected.

In July, despite a commitment to maintain front line services, the Royal College of Nursing identified 9,973 posts across 100 NHS bodies in England earmarked to go. Efficiencies of the order of £20bn by 2014 may force, temporarily, the number crunchers out of the NHS. The necessity, therefore, for employing target-managers is reduced, leading to a fall in management costs of possibly £1,850m over 3 years. Quality would be maintained – well a threshold perhaps will be met. The RCN also highlighted changing 'the skill mix' by using healthcare assistants instead of nurses. RCN Scotland estimated that 3,739 whole-time equivalent nursing and non-nursing posts across the 14 health boards were to go.

NHS Reforms July 2010

David Cameron is on record in wanting to: “scrap the whole expensive apparatus of top-down bureaucracy and inspection.” This appears to represent a complete reversal of policy. As an example of top-down policy, in mid-July radical NHS reforms were announced. The aim, according to the Health Secretary, Andrew Lansley is to create a self-managed system regulated by market mechanisms. Competing providers vie for patients patronage and, although not clear, through the commissioning of services.

The key elements of the reform are:
All providers, hospitals, mental health, ambulance services etc. will evolve into a foundation trust (FT) in 2013-14 – they will become SMPEs. There is the creation or adaption of two entities -

- Monitor, the existing regulator
- Independent Commissioning Board

The ICB and Monitor will oversee the NHS as a market. The board’s role is to hold service agreements with the GP consortia and the 8,000 GPs. It will commission services from all providers including from pharmacists, dentists and ophthalmic services. The board will provide advice and guidance. As, though, it holds the contracts, it is unclear what happens if its guidance is not followed. Who exercises the control? Monitor will evolve in to the regulator of the system, inspecting, licensing and ensuring continuity of services, perhaps like the railways regulator. Foundation status is awarded by Monitor to those that are well managed, but for this system, all are expected to be well run. Consortia must have an ‘accountable officer’ to assure financial governance arrangements are conducted appropriately. Monitor assumes responsibility for national tariff-setting – if that has any meaning. In yet another pronouncement in July, Monitor’s controls were limited to prevent its bias affecting Trusts’ choices. Monitor will tax providers, when needed, such as in the face of provision failure, using the revenue to maintain a seamless service.

- Patients > GPs > NHS Hospitals

Patients will no longer be constrained by a catchment area, they can choose any GP they wish. This, though, as with dentists, is subject to being added the GPs list. The normal cream skimming may occur at this point. The broadening of choice is seen as a good thing. But it is believed that it will destablise certain GP practices. Rather than a home-based choice, active adults may choose a surgery close to work. This will skew coping with the high cost patients to poor, residential areas.

Beyond this, the patient will have the right to choose the hospital and possibly the consultant team. As with QM under Labour, to avoid adverse selections, information

is a prerequisite. Without the measurement and league tables, how is a patient supposed to choose?

The NHS budget stood at £105bn a year. About 80% of this was given to 152 Primary Care Trusts (PCTs) to disperse to providers. Family doctors, the GPs, will be the commissioning agent. Replacing the PCTs, they will manage 70% of the NHS funds, contracting with the hospitals to buy services for their patients. Of course this is impractically complex and contractually heavy. To address this, GPs must join consortia.

Hospitals are to be privatised, but is a social way. They are to achieve a high degree of autonomy whilst being managed by employees. One expects this to be clinician-led rather than manager-led, hopefully avoiding the Mid-Staffs blind-sided management. The control structure has been likened to social enterprises, cooperatives or friendly societies. The emphasis is very much on not-for-profit, which begs the question, where do efficiencies come from? Financial incentives are the drivers of change. It is envisaged that, progressively, doctors will undertake more private work. This is acceptable provided NHS contractual obligations are fulfilled. The background to this is perhaps the notion that as techniques improve, fewer beds are needed and hospitals shift their emphasis towards outpatient services.

The patients are allowed to select their own GP and hospital. This appears to be impractical – or at least inefficient. It does not seem credible that a consortium has a contract with all potential providers from which the patient has the right to choose. As it stands, the contract is likely to be a block one, not related to individual treatments. If the GP consortium has a simple block contract with the local hospital to provide an unspecified number of procedures – i.e. an old style PCT-Hospital contract, the doctor will have a preferred provider. Indeed, it does not make sense to contract with a variety of providers – each costs money and may have a minimum usage fee built in – so that only one provider for all may be efficient but undermines parent choice. Indeed, Laurence Buckman, chair of the BMA, wrote to GPs in late July urging them to ensure that the NHS provider should be preferred and that their consortia should take on ex-NHS managers for commissioning. The status quo will be maintained as far as possible.

The competitive element, the element that drives efficiencies comes with the consortia. However, what role the ICB or Monitor might play is not clear. One suspects the will force consortia to have a range of providers to maintain a competitive market. That is, GP or patient choice will be limited or made on their behalf. However, the government is concerned about Monitor biasing the choice towards the NHS provider.

Perhaps inconsistent with the new model, two days after the reform was announced, Lansley stated that GPs will be able to utilise Local Authorities in the commissioning of mental health services. Indeed, LAs would be responsible for public health. This might represent a tacit admission that the strategic element might be missing. GPs, on an ad hoc basis, might provide a seamless and robust services but on suspects that expertise and a strategic oversight must come from elsewhere.

A Review of Schools

Elements of a quasi market in education are mentioned below. This year, government decided to [threaten to] close failing schools if they did not improve over the period of this *Update*. This is a logical step in terms of a quasi market but could be viewed as a waste of resources. There were 470 potential candidates in 2008 and possibly 280 in 2009.

With the introduction of choice plus catchment areas, the comprehensive education system produces even more segregation the grammar schools. The Sutton Trust found that the 100 most socially selective comprehensive schools only contained 9% of pupils from deprived areas, despite a 20% constituency. The most inclusive enrol 39% for deprived despite an average 30% constituency. Grammar schools were not as socially selective as this.

Results published by the Dept. of Children, Schools and Families in March indicate that between primary school and GCSEs, 65.5% of pupils make the expected progress and build on their SATs scored at 11 in English and 58.7% in Maths. Thus, out of 558,000 pupils, 200,000 were not progressing as expected. Indeed, some went backwards. Worse, research from Sheffield University presented in May found that 22% of 16-19 year-olds were functionally innumerate and 17% were illiterate. Levels of innumeracy and literacy were little changed over 20 years, despite the target and league table stick-approach to educational management.

Qualifications are a key element of measurement. They should be standardised so that the consumer understands them better over time. Another league place disruptor for GCSEs entails the use of ‘equivalent’ vocational qualifications. Civitas reported that at St Hugh’s Church of England had 39% of its pupils attaining 5 GCSEs or equivalent. This drops to 1% when only GCSEs are considered. It is suggested that bright pupils are pushed towards unsuitable vocational qualification to suit the schools league table position. Civitas suggest this is a means of ‘turning round’ failing schools. Later, the presumed superiority of Academies was undermined by another Civitas report. It found that once the unconventional qualifications were

stripped out, Academies' rate of A to C grades was worse than mainstream schools. 48% of the A to C attainment was in 'or equivalent' category.

CEO of the Royal Society of Chemistry, Dr Richard Pike, in November, proposed that exam boards that breach the expected standards in science and 'dumb down' the subject should face hefty fines or even bans. He pointed out that, the entire exam papers contain no maths in them and some questions no science. For example, a 2008 Key Stage 3 SATs paper asked a question that was more a test of literacy than science. In a reference to the competition for trade in setting standards, he suggested that boards were 'racing to the bottom' in their bids to win custom from schools and pupils. This is a possible outcome in a short term QM world.

Unison found that ⅔ of classroom Teaching Assistants are expected to actively teach whilst left in charge. Surprisingly, research by the Institute of Education shows that pupils do less well being taught by teachers supported by Assistants in the core subjects.

Research undertaken by the Association of Colleges and presented in September, suggest that there are economies of scale in education. It found bigger 6th Forms score higher marks, arguing that size allows for more specialist teachers.

The Business of a University

A framework for analysing reputation and qualifications was discussed in *Update 09*. A University is not necessarily in existence to deliver a training course or marketable worker. There are other ideals that the tradition in the UK is rightly proud. However, in a quasi market orientated higher educational environment, reputation is influenced, if not dependent on, league tables and the University is seen as a cost centre, if not a business. The price of their product, education, is the programme entry grade, which varies from course to course, institution to institution depending on supply (of places) and demand (for places). The institution is expected to find efficiencies while maintaining standards and exercising financial rectitude. Through choice for both course and institution, and based on the price of the course, the buyer, the student, maximises their utility. The provision in demand expands: that which is not contracts, and, hence, social outcome is maximised also.

The Business Model Appropriateness

Education has similar characteristics to a house. Houses are not homogeneous, simple products but a bundle of characteristics; the value of each one is difficult to

assess. It is both a consumption and an investment good: education can be enjoyed at the time as a form of entertainment or as a form of investment in human capital, the consumption of which occurs much later, after graduation and beyond. The notion of a student as buyer or consumer of this complex service is blurred with the student as the investor in human capital. For a university, the student is both the provider of funds (customer) but also the product; again, blurred.

Using the business/economic model within the provision of higher education, let us assume two types of rational, well-informed student:

- The *investor* is interested in long term rewards, possibly driven by enhancing their employment prospects. They will be interested in the course as far as their career or life choices are concerned. Perhaps this covers Lawyers and Accountants. A variant of this is *research student* who is interested in the accumulation of understanding of a narrow field of education. They may wish to become a researcher in a laboratory, or a think tank. Alternatively, they may wish to pursue a career of esteem in education.
- The *consumer* is interested in the consumption of education. They go to university to be interested and enthralled, if not entertained. Their time-horizon is limited; they seek more immediate gratification. Indeed, they are unlikely to have a career in mind. They believe that they will not be disadvantaged by attending university, but are unclear about what they might do, subsequently. A generic, non-restrictive degree fits the bill.

The investor and the research student look to the labour market to provide cues about choice of provision whereas the consumer tours the university, looking for programmes, facilities and amenities to suit their choice.

Imperfect Information

In the higher education quasi market, league tables provide information about the quality of the institution and course. To give a rounded view, the data in the tables are an amalgam of indicators, such as employability, entry points, failure rates, degree classification, and student satisfaction. One can see that some of these characteristics are inversely related and the nature of these trade-offs is a function of the type of student interested in enrolling at a university. The aspirations of the student (the customer) will affect the outcome (the product). Hence, what attracts the student to the institution and the elements of the league table that determine its position are jointly determined.

The *investor* student will look for vocational courses and is influenced by employability as the key measures. Academic rigour and the marketability of the

qualification are important. These will come through in indicators, such as employer engagement, placements, sandwich courses, unemployment rates and first destination salaries. The investor will know that a peer's undeserved 2:1 will damage the value of their 2:1. To them, the preservation of, and improvements in the quality of, the degree are central to the value of their award. Nevertheless, they recognise education as an end it itself and see the need to 'understand' before they leave university. Contact hours with staff are priceless. Assessments should be rigorous. Exams are preferable as they have value outside in the business world.

The *consumer* student will look for returns within the programme and their time at university. There is a trade-off between studying and enjoyment of student life. The programme must be challenging, but not too much so. There must be some work, but not so much that it diminishes the enjoyment of university as a phase of life. As a consumer, the student expects the tutor to provide all that is essential. The assessments should, with a limited amount of work, be doable. If not, the tutor should explain what is expected and preferably limit the effort involved in completing it. As understanding material in detail is required, exams are to be avoided, unless the material is grasped. The same is to be said for hard subjects and options.

Customer satisfaction is now a big issue in quasi markets. If, through student satisfaction surveys, the current students rate their tutors, the tutors face the dilemma of keeping their students happy against maintaining standards. This is the equivalent of the employee paying the independent body for a rating rather than the employer. If the current student remunerates the educational establishment, whereas the previous student's marketability is potentially coloured if standards are not maintained, there is a dilemma. Being a free rider, the *consumer* student wants their qualification to have marketability whilst not having to engage too much with the programme.

By contrast, the *investor* student knows that the degree is just the start of a long journey of perpetual learning. They will opt for more rigorous options, be content with exams and push for more assessment. Employability is today's problem. It is a concern that major employers, such as Waitrose and Kimberly-Clark, find that graduates are found to be barely literate. With more than 50 applicants for every training post, these companies should not struggle to fill vacancies, but they do.

Higher Education Reform July 2010

The revision of universities started this year. The government is laying out its vision for the future of English universities, stressing the 'customer experience' of students

and links with employers and industry. The discussion above about what satisfaction measure indicates suggests that although logical, relying heavily on approbation may be an unwise policy. Higher approval could mean a programme is getting better *or* worse, depending on who is consuming the service. Perhaps the satisfaction should be assessed in the context of what the institution stands for (or admit).

What the University Stands For

For some institutions, the price (entry points) has to be in certain hard currencies. In January 2008, Cambridge University listed 20 'A' level subjects, including Art and Design, Dance, Film Studies and Media Studies, that should be avoided as part of the three 'A' levels normally needed to obtain a place. This would work against State schools as 14% were avoiding more difficult programmes in 2009, such as Geography and Physics and 10% did not enter a candidate for Chemistry, whereas 40% of Private School candidates took Maths. By demoting the certain 'A' levels, it places a question mark over the value of the corresponding degrees.

A university, by creating a portfolio of courses and outlining its prices, signals to the agora the variety of student it believes it can attract. In other words, part of its reputation is based on the price and quality of its programmes of study. Here is the rub in a cost driven world. The pressures that universities face drive them to reduce contact hours and lower quality, elements that are not obvious when choosing a degree. The Business Secretary, Lord Mandelson, in November, suggested that students should have more information about teaching quality and likely future earnings. As with the discussions about reputation of BP, the outsourcing of the quality of degrees and the well-being of universities to the market and expecting rectitude to prevail is foolhardy.

David Willetts seemed to misunderstand the nature of higher education by suggesting that a local college could teach a university degree. The presumption was that an Oxford degree could be taught by Oxford College of Further Education Institute Trust. It is more efficient. The net cost of teaching an Oxford undergraduate in 2008/9 was £7,000, whereas the typical Russell Group University student net cost was £1,700. A Chemistry student from the Russell group costs more, £3,600. Thus, the shift could be beneficial cost-wise but…. is there not a conspicuous consumption element?

Vince Cable in mid-July, mused, before the spending review or the Browne report in October about reforms in higher education. Consistent with a quasi market business model, he announced that institutions could go bankrupt. Of itself, this should have been predictable. Like with banks, knowing the state would bail them out, there is

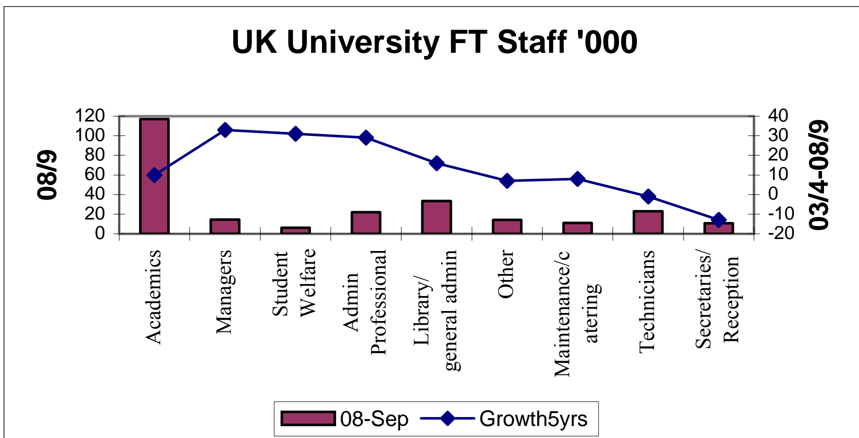
the inevitable moral hazard of profligate institutions not putting their affairs in order. Two candidates are prominent:

- Cumbria University was forced to borrow from next year's income to pay this year's wages. A campus was closed and student moved. Opened in 2007, by 2010 it had debts of £30m. The VC, Peter McCaffery, left in May and, following a review by David Fletcher Consulting, which found shortcomings in the way the university was being run, Peter Ballard the chair and 6 of the 21 board of governors announced in July they too were leaving. Still, the plan was to attract 200 extra students by 2012 and cut staff by 200.
- In December, one of the largest universities, London Metropolitan University was ordered by Higher Education Funding Council for England to repay £36.5m after issuing false data on student numbers. It emerged that the former vice-chancellor and members of the board of governors were aware that unfair funding claims were being made.

The threat of failure will act like a run on a bank, it will only make matters worse. Will those 200 extra students be attracted?

Cut the Slack

As with the NHS, the quasi market in higher education has led to an engorged management structure. The FT reported in February that the number of managers in the academic year 2008/9 was 14,300, a growth in numbers of 33% over 2003/4, whilst the number of academics had grown by 9.9% and all non-managers had grown by 10%.



As in the NHS, managerial goals of the firm point to size of staff base as a measure of success. Surrounding oneself with underlings and paying yourself well could be markers of a CEO's achievements.

Graduate Tax

With deindustrialisation old staple industries are disappearing so are the corresponding blue-collar jobs. The new industries require more education. Fearing a tough life of the minimum wage and insecure employment in the secondary labour market, more families feel they need to get their children into university. Also, given the numbers in the labour market a degree, it is not the advantage it once was, not having one, though, is a disadvantage. This discussion places higher education as an investment good rather than a merit good. The returns from a qualification can be assessed from results from the Sutton Trust's Mobility Manifesto report. Suggesting that helping the poor to achieve better qualifications will assist social mobility, it provides the following estimates: over a working lifetime someone with 'A' levels earns on average £268,000 more than someone that fails to get 5 good GCSEs; a degree holder earns, on average, £108,000 more than that at £604,000.

Cable also suggested that a graduate tax should be considered. For the government, a loan scheme or a gradate tax implies an expenditure stream at a time when income is needed. Interestingly, Cable suggested universities could borrow from banks using the levy on students as collateral. This pronouncement came at a time of 225,000 excess demand for places; 1.7 applicants for every place. A rise in price could choke of the excess, or an increase in non-traditional providers, such as BPP.

The tax should not be greater than that which makes graduates indifferent to higher education; after all, there is a risk element. Perhaps the US costs may make a UK student feel better. A four-year degree at MIT, in the US, where Paul Krugman teaches, costs a student $50,000 (£32,600)/year (or $200,000).

At least some of the market value of a degree is based on who delivered the award. Those with a great reputation, such as Oxford, have little interest in devaluing it, whereas franchise colleges only have to fulfil a contract, subject to a quality threshold, so Willetts is probably mistaken. Distance learning or correspondence courses are also flawed for the same reason: there is no substitute to conversing with a leading, experienced academic in class.

As they now constitute over half of all awards, unconventional qualifications caused a shake up of the university entrance process managed by UCAS in July. This is a poor outcome. Unconventional implies poorly/less well understood. Yet another

idea floated by Cable is the two-year degree. This is another tinkering with a system that could disadvantage those on such a degree, making it unconventional. In a common market, mutual recognition of qualification is necessary. UK 2-year ones may not be viewed in the same light as 3, 4 or 5 year ones on the continent.

Devolution

Using a business model, powers are to be devolved to GPs who, in groups, would buy in management skills needed. This represents a move away from PCT allocations to self-funded management and individual contracting. Like the Schools-LEA link, these groups could contract with the authority which they were formerly allocated funds by. The CEO of the NHS Confederation, Nigel Edwards, sees a market place more akin to one with many buyers and sellers rather than an oligopolistic one. Indeed, GPs will shape the services and direct strategy for hospitals by telling hospitals what they need for the longer term. However, in a quasi market, these GPs must be financially astute if not profit oriented. Perhaps it is better that, for the sake of public confidence, GPs do not appear like medical entrepreneurs. But then, do people mind head teachers being CEOs?

Parents are to be given the right to set up their own school. The end of the school construction programme should preclude this or the possibility of a poor school closing down, others expanding, or being set up. There is little money for this, so a key threat of bankruptcy (close-down) is removed. However, the EC Harris building group suggested, in July that, as one-eighth of retail property in the UK is lying empty the cost of making a free school available by adapting these buildings would reduce the cost of new schools by 30-36% @ £13-£17m in 20 to 35 weeks. Whether the shop is in the right place is another matter.

Devolving powers to primary schools so that they can choose to participate in SATS tests is, perhaps, a step too far for the government. In May, the SATS tests for 600,000 10 and 11-year-olds were boycotted by 4,005 of the 15,515 primary schools. The SATS are not essential in a non-league table world, so the commitment made by Gove to next year's set is instructive. Interestingly, though, Academies are permitted to de-enlist from the National Curriculum.

Quasi Markets – Where are we Now?

Choice, competition, inspection, audit and league tables are central to the allocation of resources in this system. Gaming poses problems, so audit and authentication is necessary. With quasi markets comes a major bureaucratic apparatus. Dispensing with measurement will release resources. It was estimated that more than 20,000

managers' jobs set to go with the abolition of both Strategic Health Authorities and Primary Care Trusts. However, it undermines the whole allocation process. Consumers need reliable data, which will not be provided by those public sector administrators that face a moral hazard of twisting the story to suit their own ends.

Hospitals and schools are encouraged to achieve earned autonomy; Foundation Status or Academies are examples. This devolution changes the roles of the professional. Today a school leader can be a Chief Executive Officer (CEO) rather than a head teacher. The business model allows that practice, for example, for schools to pool their resources in order to get better prices on items, such as the computers or furniture, by making bulk purchases. Those that are run well make surpluses (profits). These CEOs will be responsible for large budgets. As with other CEOs, there will be a temptation to award themselves large pay increases and bonuses.

The great losers are the bureaucrats that Cameron wants out. PCTs and LEAs will be neutered. Without armies of auditors, inspection will be a 'light touch'. The shifts towards empowering GPs and aims rather than targets are developments that, if you believe that professionals make good choices for the benefit of society, are to be welcomed. The government will have to trust the providers. What is not consistent with this is that some data is still collected; financial penalties are still being used; and there will be a market with GPs buying services from hospitals, so we are not quite at the end of the quasi market road.

Airline Concerns

As has been the recent history of airlines, large losses are a feature. As regulation catches up with the needs of the industry, more mergers, cost cuttings and surcharging emerged during the year. Insureandgo reported in November that possibly 76 airline routes from London airports had been withdrawn in the 18 months to October. This amounts to 646 flights or 95,000 seats a week. BMI announced in November that it would withdraw routes from Heathrow to cities, such as Amsterdam, Kiev, Brussels and Aleppo. Due to a shortfall of £190m, landing-slots are to be sold and jobs will be shed. This indicates the problems faced by certain airlines.

In November, British Airways and Iberia agreed provisional deal to merge and create one of the world's biggest airline groups. The new company is to be called International Airlines Group. The history of the merger is a long one, littered with false dawns. In 1998, BA took shareholding in Iberia and further developed

cooperation on routes between the UK and Spain in 2003. BA had ambitions over Australian flyer, Qantas, and US giant American Airlines, but these fell through. In February, BA finally made progress on its ambitious plan to merge/work closely with Iberia and American Airlines, their co-members of the Oneworld group. The US Dept. of Transportation gave BA and Iberia preliminary approval for a deeper alliance with AA provided BA gave up 4 pairs of landing slots on the Heathrow US route. Virgin objected. This EU waiver agreement entailed making seven daily slot pairs available to other carriers: three on the London-New York route, two on London-Boston and one on both London-Miami and London-Dallas. In April, it was formalised and in July, the European Competition Commission approved the merger and closer cooperation with American Airlines. This was followed quickly by approval from US authority.

Progress was probably more rapid this time due to antitrust approval granted to other tie-ups. After dancing with each other for some time United Airlines (of the Star group) and Continental Airlines (formerly of the SkyTeam) agreed merger deal that created the world's biggest carrier. Merger talks between United Airlines and US Airways had faltered just days before. The four-week period of talks was the second round of merger discussions between the firms since 2008. In June, the United-Continental tie-up was considered by the Senate. It was the fourth since 2000 of significance. The new company, United Airlines, worth $3.2bn flies to 370 destinations carrying 144m passengers a year. The merger, driven partly by costs, is hoped to deliver savings of more than $1bn a year. The merger is expected to be completed by the end of the year, but still requires regulatory approval.

Approval may become more problematic in the future as the Federal Trade Commission and the Dept. of Justice are in the process of considering updating advice on antitrust issues. As in the UK, law-makers are increasingly looking to economic models to guide the merger and competition processes. Competition and merger theories can provide conflicting views. From an SCP basis, this merger is very bad for the consumer. It will lead to a worse service and higher fares. However, as airlines are the classic CMT example, the merger does not matter so long as the markets are contestable.

Pricing policies become difficult to judge. The US is concerned about Upward Pricing Pressure resulting from a merger not specifically concentrated within the market. This avoids the need to specify the market concerned and focuses on pricing behaviour alone. Alliances could change the means by which competition is measured. If two flyers are from the same group dominate a route, does this suggest that there is rivalry or not? Battle Group suggests that where international routes

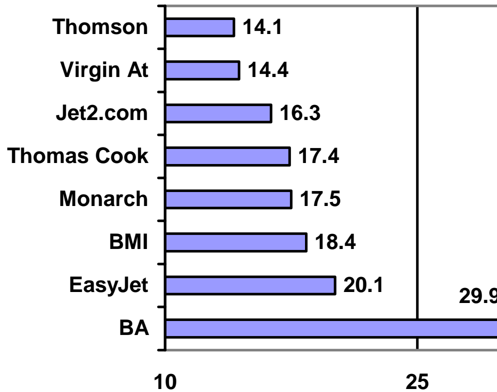
were dominated by flyers that are part of the same immunized group members between 1999 to 2004 fares rose significantly.

Since 2000 though, US airline companies have made a combined operating loss of $15bn. This moves the mergers away from a concern about excessive profits towards a necessary restructuring to ensure survival. Will this merger result in any difference given the losses have yet to be stemmed so far? Following fuel terrorism and economic crises, some are facing life-threatening losses. Code sharing has not led to a stabilisation of the balance sheet. A further step beyond code-sharing is a joint purchasing agreement. Star group is exploring means of harmonizing processes of reservations and luggage handling and joint purchasing of catering. Rationalisation is necessary: it requires capacity to be reduced and prices rise.

Labour Cost

Following earlier job cut announcements, in November British Airways stated that it was to cut a further 1,200 jobs taking the total plan to 4,900 positions by March 2010. This followed the first first-half loss of £292m. This precipitated a rather nasty dispute. One of the problems facing BA was its cabin crew cost, which, at £29,900/head/year, was expensive. One of the early, limited strikes led to the withdrawal of company perks from the strikers. This became a major stumbling block, as both parties became more entrenched over the return of these perks.

The dispute took a malevolent turn in June when BA set out to recruit 1,000 cabin crew for Heathrow, hoping to pay them an average of £18,000, around the same as the average 1,200 Gatwick staff, but less than the £35,000 the existing 11,500 Heathrow cabin crew were costing. By the time of the announcement of the BA-Iberia merger approval, two waves of strikes had cost BA £248m plus a loss of good will from passengers and cabin crew, but it had gained some cuts in operating costs worth £60m. Yet another ballot in July, rejecting the airline's 'final offer', left BA and the Unite union in dead-lock. Some of the travel concessions were to be returned and there was a 6% pay increase over two years on the table.



Relocation

In August and September low cost airlines based in the provincial London airports decided to relocate to reduce their exposure to higher landing fees. easyJet, based in Luton, claimed that landing fees had risen by 25% in three years and with the £10 Air Passenger Duty, dubbed a holiday tax, the airline decided to reduce flights out of Luton by 20% and close its East Midlands airport services all together.

Surcharges

The flyers AA, Continental, Delta, United and US Airways introduced surcharges of $10 to $30 for one-way domestic flights for most days in the peak summer period. They were switching to peak load pricing or price discrimination by time to avoid major shift in a fees systems. Surcharges do not require a change to the fare structure and prevent consumers becoming baffled by tariff changes when flights are combined. The feeling is that the business traveller uses the airlines out of necessity and so is price insensitive. Reducing capacity and raising price will squeeze out the budget fare, increasing the revenue per paying passenger.

BA decided to unbundled yet another charge. It decided in September to charge up to £160 for a long haul and £20 for a short haul to choose a seat. This follows a decision to remove free meals from short haul flight. Ryanair increased luggage fees for the busy months of July and August by £5 to £20. Based on 30% of passengers checking-in baggage, this was expected to raise £23.2m or 7% of recent net profit.

Other charges that existed include £5 checking fee on-line and £40 for printing out a boarding pass. Ryanair is famous for penalising flyers for stowing luggage, encouraging customers to travel light. There is a logic other than the increased turn-around and lower handling costs. Reducing an aircraft's weight by 1kg saves £63,000 in fuel over a 30-year lifetime of a plane.

Low Pricing?

A complaint made last year by the European Commission about Ryanair and low budget airlines, hooking someone in with apparently low prices, was, in September 2009, also levelled at electronic goods retailers on their websites. The Commission found 55% of the 369 websites investigates gave partial or inaccurate information and failed to inform consumer of their rights. Most airlines promised to correct the weaknesses. One would expect this pattern to be repeated.

A Sick Passenger

In September 2009, Delta indicated that it was in talks with Japan Airlines. Of itself, this has competition issues and only likely to be approved if Open Skies agreement is forged between the US and Japan. However, the added spice is that these two are in different world groupings. Having a joint venture with AirFrance-KLM and with Northwest Airlines in the Sky-Team, it is a relatively concentrated group. The loss-making JAL is the second largest by revenue in the Oneworld group, which includes BA and American Airlines. Upon the news breaking, American Airlines offered an equity injection to JAL.

This competition for a financial basket case is perplexing. The Japanese government was concerned about JAL going into bankruptcy, so the competition may help avoid an embarrassing flag-carrying failure. It may be that despite the losses, strategically access to the Asian markets by US flyers is vital. Thus, the competition may represent some game theoretic interplay. International flyers rely on the strength of their partners: the stronger the partner's domestic hubs, the greater the likelihood that an international flight will have sold every seat. By January, JAL was close to failure and collapsed on 19th, worth the price of just one jumbo jet. This was the same day that Kraft bought Cadbury, for £11.5bn. The restructuring group were keen not to receive injections from Delta or AA.

	Passengers/yr	Fleet
Star	330m	2269
Oneworld	507m	3332
Sky	462m	2496

Concurrently, the other Japanese national flag carrier, All Nippon Airways, was seeking an alliance with Star-Alliance co-member, Lufthansa. Lufthansa in August 2009 was seeking regulatory approval for a code sharing agreement with JetBlue. The goal could be to access New York JFK landing slots. This followed an injection of equity of $300m in 2008.

Location-Airport-Location

As Lithuania and Latvia suffered from the recent recession, the UK has seen a 100% rise in the number of EU students from there. Combined, Latvian and Lithuanian applicants in 2010 were greater in number than that from France. This is partially associated with cheap flights, leading to the coining of a new phrase, 'the Easystudent'. Universities near to where low-budget airlines are based benefit from the patronage of a rise in the number of students. The University of Bedfordshire benefits from easyJet's base at Luton. As the extreme, 11.4% (1,400) of its students are of this type. A problem that the government has yet to tackle is the repayment of the loan taken out by the EU student. It is estimated that 70% of those who should be now repaying the loan are not doing so.

Open Skies II

In June, the EU transport ministers signed a second 'open skies' agreement. Following a preliminary agreement at the end of March both the US and EU claimed victory. The main sticking point on open skies I in 2007 to be addressed in open skies II, at least for BA, was a 25% foreign ownership limit on US airlines. John Byerly, chief US negotiator, announced: "no requirement for change" on the ownership rules. US flyers won greater access to Heathrow and a clause allowing the suspension of negotiations if ownership issues were not progressing was dropped. It is likely, though, that the US would have retaliated to any suspension with a withdrawal of anti-trust immunity. But it still fails to look like a win for Europe.

US-Japanese open skies were also in the news. Landing slots at Tokyo's Haneda airport, sought by United and Continental Airlines to gain greater access to Japan were awarded to Hawaiian Airlines, Delta, and American Airlines. This leaves Continental and United with access to Japan only through All Nippon Airways. Slots at Haneda are highly prized for their superior access to central Tokyo compared with the international hub at Narita, making it more appealing to price inelastic business travellers.

Until the open skies agreement in December, access to Japan was restricted. NorthWestern had favourable access with benefited Delta. With the opening up of Haneda to international traffic Narita's monopoly on international travel will be undermined and so Delta's. Naturally, Delta asked for all four available slots. The Dept. of Transportation favoured Hawaiian as a new entrant to enhance competition. Also, American Airlines was awarded, provisionally, the key New York-Tokyo slot because it is part of the Oneworld alliance, which is currently under-strength in Asia compared with Star Alliance and Sky Team. Evidently, slot allocation is based on rivalry between groups, not between airlines.

General Motors Europe

Following its rapid restructuring under Chapter 11 bankruptcy regulations in 2009, GM sought to dispose of/ find a buyer for General Motors Europe (GME). It produced vehicles under several badges, including Saab, Chevrolet, Vauxhall (UK) and Opel (rest of Europe).

The NIDL presumes that production is footloose and that factories are like any other asset that can be bought and sold. This may not be so in certain parts of the world. Extricating oneself from a poorly performing industrial complex can be time consuming and costly. There are political sensitivities and possibly significant redundancy costs. General Motors was seeking to extricate itself from building cars in Western Europe. To be marketable, economies had to be found and possibly factories had to be shut to turn the loss-making GME around, but where?

Key variables for GM are laid out below. GME produced vehicles primarily in Germany and Spain plus the UK, Sweden, Belgium, Poland and Russia. As Polish labour costs were about a third of those in Western Europe and GM was targeting Russia as a future growth market, these factories were not considered for closure.

MNE are adept at playing one country off against another in the competition for the footloose plant and the concomitant jobs that direct foreign investment provides. Commonly, there is a sort of bidding war for a new plant were the costs of production are softened by state aid provided by local authorities but, in the case of GME, the company could request state aid to keep plants open. Ideologically, some countries are more amenable to providing state aid than others. Beyond this, certain factories were more efficient than others. The standard measure in the car industry of efficiency is hours-per-car. The most (14.9) and least (33.1) efficient plants were located in Germany. Polish production was inefficient (31.6) but, with modest wages

by western European standards, this was offset. The Spanish plant was both large and efficient. In between, the Bochum, Belgian and the UK plants, which built the Astra, all had about the same level of efficiency.

The table below also shows the models, the production, number of employees, number to be made redundant, and the percentage of the workforce to go.

	Plant	Model	Hour/ car	Jobs	Redundancy	Production	% job loss
Poland	Gliwice	A, A-Classic, Z	31.6	3582	0	171523	
	Eisenach	C	14.9				
Germany	Russel-sheim	V, Signum, Insignia	33.1	24700	4116	474557	16.7
	Bochum	A, Z	24.4				
UK	Luton	Vivaro, Nissan Primstar, Renault Trafic	24.2	4475	1373	198852	30.7
	Ellsmere Port	A, A-Van	23.2				
Belgium/ Luxemburg	Antwerp	A, A-Twin Top	25.2	2584	2517	132426	100
Spain	Zaragoza	C, C-Van, Meriva, Combo	19.5	6401	2090	423011	32.7
Sweden	Trollhatton	Saab		3892	N/A	40,000	
Russia	St Petersburg	Chevrolet		985	0		

A=Astra Classic Z=Zafita V=Vectra C=Corsa

In early August, GM was happy to sign an agreement with RHJ International. It had significant concerns about rival bidder Magna's demands over intellectual property and its use in Russia, a strategically important market for GM, without compensation. RHJ International was looking for €3.6bn in state aid and was offering €275m for 50.1%. Magna wanted €4.5bn in state aid and looked for €265m in cost cuts. In theory, state aid cannot be used to shift unemployment around Europe. The European Commission does not permit an aid-jobs agreement, but it is obvious from what went on that national governments seek to protect national interests so do engage in social dumping. The German government put GM under extreme pressure to choose Magna over RHJ International probably because it entailed job cuts primarily outside Germany.

Magna is a car and parts manufacturer its own right, building cars under licence in Austria and had 75,000 employees. The new unit was to be owned: Magna International (27.5%); Sberbank (27.5%); 10% worker's trust; and GM retained 35%. Sberbank is a Russian bank with close links with Gaz, the Russian industrial group. GM has a joint venture with Avtovaz, building Chevrolets in St Petersburg. The idea was that GME would help restructure the Russian car industry.

Job Losses

Of the 55,000 GME jobs, Magna planned to cut 10,000. The proportions of the job losses per factory group are indicated. Despite the heavy presence in Germany, only a quarter of the losses were based there. The concern was that the job cuts will not necessarily fall on the weakest parts of GME but on those that provided the least support for the deal. The German Government had promised €4.5bn of state aid to support the restructuring. Outside Germany, the Belgian factory was to close and Spain and the UK would lose 30-33% of their workforces. On the standard efficiency measure, the Eisenach plant was the most efficient. Producing just one small model helps this. The least efficient was Russelsheim, followed by Gliwice. The least efficient produces a car in twice the time of the most efficient.

Neelie Kroes warned repeatedly against job poaching and the Belgian premier sought a meeting with her. Mandleson wrote to her questioning the viability of the agreement on the 23rd September whist thousands of workers from the Antwerp plant protested. Spanish industry minister, Miguel Sebastian, wrote to the EU industry commissioner, Gunter Verheuggen, on the 27th to complain about the disproportional job costs whilst the Spanish plant was more efficient than some German plants. An Insignia was built at the Russelsheim in 24.85 hours. To make matters less clear, he suggested that, given its size, a Corsa should take ⅓ as long to build compared with an Insignia. Moreover, it emerged that the Brussels' plant could receive up to €500m in state aid and there was a plan B: make something other than Opels.

The takeover was further complicated by Magna's dual role. VW and BMW expressed concern about the relationship with Magna as a supplier in mid-September whilst Magna was to become a competitor.

Magna wanted to cut about 1,300 of the 7,000, Spanish workers. The plan entailed relocating a production line to the more efficient plant, Eisenach, shifting jobs to Germany. Negotiators whittled down job losses to 900. Once this was agreed, the Spanish industry minister, Miguel Sebastian, was in no mood to renegotiate.

The Luton plant looked vulnerable. On 2nd October, Tony Woodley of the Unite union suggested that van production was due to shift to the Gaz group in Russia. As both Magna and GM saw Russia as a key market, when a Renault contract ended in 2013, the Luton plant seemed destined to close. Representing Vauxhall workers, Unite, in mid-October, reached a deal with Magna to limit job cuts at the two UK factories to just 600 people. Unite leaders agreed to a two-year pay freeze and other cost-savings in return for having no compulsory redundancies.

In mid-October, GM was looking for more state aid for job cuts that Spain and the UK were refusing to provide. In the same week, 16th October, Neelie Kroes found that the preconditions for the German state aid were incompatible with competition rules. GM was finding making progress very difficult.

Same Job Losses, Different Distribution

In early November, GM decided to withdraw from the sale of GME to Magna and announced its own 10,000 job-cut requirement. The Magna deal had been deemed unfair by competition authorities, as well as unions and politicians in Spain, Belgium and the UK those with the most to lose. Hailing the sale to Magna as a triumph German, unions were happy but Spanish, Belgian and British were not. The change of heart over the sale by GM provoked strikes in Germany and the German government, demanding the repayment of a €1.5bn bridging loan. German trade unions feared that Opel's plant in Bochum could close under the GM plan, whereas under the Magna agreement they had been given a guarantee that all factories would have been kept going.

In December, the new CEO of GME pledged to safeguard almost all of the British jobs until 2013. Of the 8,300 jobs to go 5,000 would go in Germany and only 350 would be lost in the UK. Indeed negotiations were then going ahead with Renault for the next generation products at Luton, and €250m investment in other new developments.

In February, GM announced a €11bn investment plan in Opel over the following 5 years. Of this, €1bn would be in fuel-efficient engines and alternative technologies. This seemed at a significant turn around given the financial position just 12 months earlier. Indeed, the American part of GM is prohibited from cross-subsidising other elements. So this was unexpected.

GM was looking for other investors and sources of funds. It put in a request for €1.5bn loan guarantees from the German government. Sadly for Opel, on 8th of June the German government refused to supply guarantees on €1.1bn of loans. GM's aspirations had been progressively reduced so it was not expecting a guarantee on all but it was expecting at least 25% of these guarantees. It then decided to withdraw its application for support citing governmental procrastination. No loans and no disposal. A year of negotiations for no result. Perhaps, it bought GM time whilst it lived of the fat of scrappage schemes world wide.

The Strategy Analysis

Aaron Bragman of IHS Global Insight argued that it was in GM's interest to retain its European operations in the long run, but were force through adverse circumstances to put it up for sale. Opel's engineering generates a significant number of GM cars and Opel is central to GMs global competitiveness, in particular in Russia. Perhaps recognizing this, Russian Prime Minister Vladimir Putin criticised GM's decision to abandon the agreement, but said his government would still support the US carmaker's projects in Russia.

It has been estimated by Credit Suisse that the minimum efficient scale for the Astra platform, the car produced at Antwerp, is 600-800,000. The plant produced 132,426 in 2008 and GME built around 450,000 units on that platform. GM needed to expand not contract.

Closure

The Antwerp plant in Belgium was scheduled to be run-down under all scenarios. The Belgian PM's office was concerned that the 2,600 job losses represent nothing more than protectionism. In April, an agreement with the unions was struck to close the plant. The planned closure of the Antwerp and running down of Luton and Zaragoza plants ring hollow in the ears of Belgian, British and Spanish automotive workers. Below are case studies of restructurings that disfavoured Britain and Belgium.

Building the 309 from 1985 Peugeot expanded production at the Ryton plant in Coventry in 1987 with the 405. This ended in 1995. The 306 was built there from 1993 to 2001 and the 206 began in 1998. After failing to win the replacement of the 206, Peugeot decided, in April 2006, that the Ryton plant would close during 2007 with a loss of 2,300 jobs. Professor Garel Rhys, of Cardiff University, suggested that Ryton, plant was 24% more productive than its sister facilities in Poissy, France and its third most productive plant in Western Europe. At the peak of 206-production in 2003, it made 67 cars per worker. PSA Peugeot Citroën relies heavily on their home market and, as such, it is eager not to offend their customers. Given the support the French government gave to its car producers in 2008/9 you can understand why.

In the event, consistent with a NIDL prediction, production was shifted to Trnava in Slovakia. The high cost of making the old 206 in the UK relative to the low price and the plan to sell the car outside Western Europe meant it made more sense to build it in factories in Eastern Europe and elsewhere in the world. According to Centre for Automotive Research (Germany) wages in the automotive component

industry in Western Germany in 2005 were €25.8/ hour. In the Czech Republic they were €4.2 and Slovakia: €3.3.

Belgium has a long-standing tradition in car assembly. Having provided direct employment for 33,000 people, Belgium had assembled cars for Ford, General Motors, Volkswagen, Volvo (Daf) and Renault. Belgium assembled more cars per capita (500) than any other country. Situated in Vilvoorde, one of the largest industrial areas in the Northern suburbs of Brussels, in Feb 1997, Renault announced the closure of its car plant, resulting in the loss of more than 3,100 directly employed workers plus a further 1,500 employees in the supply chain. Over-capacity and high costs were cited. The unions, though, criticised Renault for not honouring commitments, such as new investment, which was expected in exchange for greater flexibility in the early 1990s. More widely, the decisions regarding these plants of Ford *et al.* were taken at the HQs of multinationals based outside Belgium. Indeed, the political environment in countries like France and Germany meant that ownership matters. A plant is more likely to be preserved if its company's HQ is local.

US Car Restructuring

In the US, the new GM, Chrysler and Ford have made significant progress in the area of quality. The JD Power survey of customer satisfaction found that the 3 US companies' new cars had an average of 108 defects per 100 cars, which was down from 164 in 2000. Foreign brands started the decade at 141 and this year had 109 defects. In other words, the US cars are much improved and are, indeed, superior-build models.

GM is not the only element that has recovered. In January, shares from the bankrupt company valued 'Old GM' at $500m. The company, now known as Motors Liquidation Company, owns 200 properties and over 500,000 contracts it was bequeathed.

US and European restructurings were different. Not one European car factory was shut down in over 2007-2009 when GM planned to close 11. Despite GMs restructuring in Europe, Saab and Opel's factories by the end of 2009 were not closed. Moreover, the US ownership of European brands of Jaguar, Land Rover, Volvo, Saab ends. Only Vauxhall/Opel remains. As a reverse, FIAT became the third non-US car company controller of Chrysler – for no charge.

Suppliers

Since GM came out of receivership, it has had to face the consequences of the way it behaved in a previous life: it relies on the companies that it formerly abused. It spends $74bn on supplies. It is now recognised that it needs to rebuild relations with is supply chain. Profit is now being shared better. Before the collapse an innovation that reduced costs would benefit the supplier by just 35% of the benefit in year one and nothing from then onwards. Under GM executive in charge of the 6,700 purchasing employees, Bob Socia, the benefits are shared equally. Suppliers' cash flow is improved by weekly, rather than monthly, payments. These improvements have led to an increase in the flow of cost-cutting ideas of 322/month, up from 206.

Ford is also changing its relationships. As they expire, agreements with smaller, weaker suppliers are transferred to larger ones. The aim is to achieve economies of scale through a new strategy of single suppliers for components. For example, a 40% reduction in development costs for the seats for the latest Ford Focus has been achieved by signing a global contract with Johnson Controls.

Moreover, in what appears to be a shift towards more lean production relationships, suppliers are given access to vehicle development plans at an earlier stage. As with GM, FIAT-Chrysler in the US has reduced payment periods on supplies from 9 to 3 months and reimburses a higher proportion of R&D costs for new components upfront. As noted by the head of Ernst and Young's Automotive Practice Unit, Mike Hanley, the US car manufactures are moving towards a higher trust relationship with their suppliers.

Delphi

Delphi U.S. filed for Chapter 11 bankruptcy protection in October 2005 and was subject to support from General Motors, its former parent and the US government in 2008. However, the company had a range of 'non-core' products made outside the US. Delphi was intending to close 20 of its least productive plants and transfer production to areas of lower labour costs. The United Auto Workers (UAW), the largest Delphi union in the US, had already agreed to cut workers' wages from $27.00/ hour to $18.50 and for factories to close.

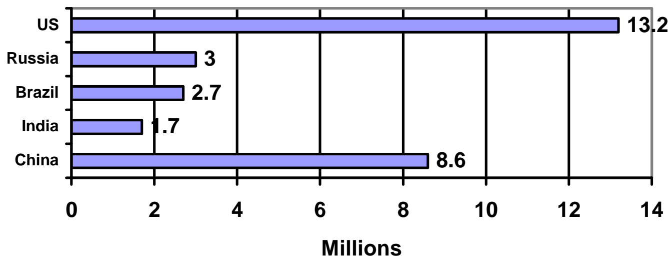
In the 1980s, Spain was a low cost provider, but this is no longer the case. Given what has been discussed elsewhere, Delphi would have itchy feet. Consistent with NIDL, the lure of Eastern Europe and Asia would be a strong draw as a replacement. Producing components for DaimlerChrysler, Ford, GM, Kia, Nissan, Renault, and Volvo, the Puerto Real factory in Spain made bearings and steering system

components. In February 2007, Delphi announced its closure costing 1,600 direct jobs with a further 3,000 indirect jobs. Union and government estimates put the total at more than 5,000. Cadiz had the highest unemployment rate in all of Spain a high unemployment country. As a result of the announcement Opel and Peugeot exercised options to terminate Puerto Real's supply contracts, sending the work to GKN. The Cadiz government had provided $20m in 2005 with an agreement that ran out in 2010. Despite this, it was asserted that Delphi violated terms of its financial incentives package by transferring manufacturing equipment from Puerto Real to a sister plant in Poland. With similarities to Peugeot, almost immediately after the plant closure in Spain, Delphi announced that a new factory in Romania would be built. Completed in 2012, it will produce injectors and other components for diesel engines and employ more than 1,000 workers. Moreover, it extended production facilities in its Tangier plant through a major investment and an increase of the workforce by 3,000 workers. Both Romania and the region of Tangiers are close to major EU market and offer cheap labour, tax incentives and weak environmental restrictions.

Winners

An odd winner from the credit crunch was Renault. Its Rumanian plant, in Dacia produced a low priced car for the eastern European market. At as low as €5,000 the car is modestly priced. With the car scrappage scheme in France and particularly Germany being so generous, customers could acquire a car for €2,500 in Germany. Sales for the first two quarters of 2009 sales in Germany were 40,000 and 25,000 in France. Only 23,000 were sold in Romania.

Another winner out of the distress in European and the US manufacturing appears to be China. China has the second largest car market in the world, larger than Germany but less than the US. It has a nascent car industry but, in keeping with other elements discussed in this *Update*, China is keen to move up the value chain.



China is also shifting toward developing a vibrant car manufacturing industry – through acquiring distressed assets. Rather than buying the whole company, Shanghai Automotive Industry Corporation (SAIC) waited for Rover to collapse and then acquired what it wanted, the technology. Perhaps the same was attempted over Saab. In yet another reverse of the predictions of the NIDL, Beijing Automotive Industry Holding Corp (BAIC) offered $400m to buy it in early September 09. By November, the Saab sale was off. In December, for $200m, BAIC acquired vehicle platforms and other technologies from Saab. By April, it was displaying prototypes for the passenger cars developed on the Saab technology.
Looking to other buyers, Koenigsegg's attempt to buy Saab in June 2009 could not be fully funded. The Swedish government appeared sanguine that its non-intervention in the once high profile car industry was appropriate. It pulled out in November. It was believed that, after a number of attempts aborted to preserve the brand by Spyker, Saab was unmarketable and, in January, GM began winding it down. Even then, an F1 consortium made a bid for Saab. Finally, in February, for $400m, Spyker became the owner.

This comes on the heels of another Chinese company, Geely, expressing interest in Volvo and Tengzhong Heavy Industry offering to buy Hummer. The latter being agreed, in October, a price of $150m but the Chinese government intervened to prevent the exchange. Geely may have made an offer of just under $2bn in August 2009 and tried again soon after. It was suggested that it was looking for an upmarket marque, but also technology. As with GME, Ford, its then owner, was concerned about the its intellectual property leaking to China via Volvo. In the end, though, Geely did acquire Volvo for $1.8bn in March. Losing money afterwards, Ford paid $6.45bn for Volvo in 1999. The takeover was the largest acquisition of an overseas carmaker by a Chinese company. Interestingly, the first pronouncement about models in August 2010, by Li Shufu, chairman, was to suggest Volvo is to move upmarket to compete with the BMW-7 series and Mercedes-S class.

Green Mergers

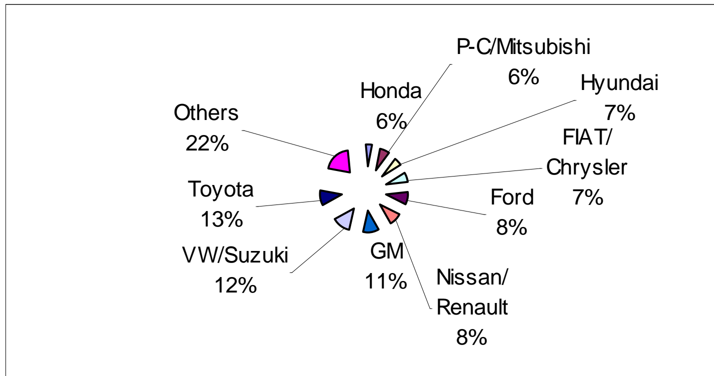
Chrysler needed small cars and FIAT could do with ‘heftier’ ones, hence the 2009 merger provided both parties with a reasonable fit. FIAT needs to raise production to 5.5-6m units from a combined 4m. To complete the metamorphosis, FIAT decided to separate the car element from the rest of the conglomerate, focusing on the FIAT-Chrysler brand. From the automotive unit, the plan, to 2014, is to develop 51 products, of which a third are to come from Chrysler.

In April, Renault/ Nissan announced a cross shareholding deal with Daimler. On the face of it, this allowed rivals access to Daimler’s valuable engine technology and the potential to damage a premium brand (again), so why engage in the share exchange? The answer appears to be a regulatory one: carbon emissions and fuel efficiency. In the same month, Obama introduced fuel efficiency targets of 35.5miles/gallon. Large, sporty cars manufacturers, such as a Porsche face significant challenges with both. With its 911 having an emission rate of 230 CO_2 g/km in 2009, along with other manufacturers, Porsche must get this to 130 by 2015 and to 95 by 2020. The emission are assessed on the average in the fleet so, as they tend to have lower emissions, having a wide small car base is important to a manufacturer. FIAT, the lowest emitter by weighted average had, in 2009, a figure of 127.8 and is the only one within the 2015 target. Mercedes at 176.4 and Renault at 137.4 are at different ends of the spectrum.

These regulations could spell the end of independent sports car manufacturers. Indeed, Mercedes are just one of many emissions driven deals. Unrelated to this, but still helpful, the audacious purchase of VW by Porsche failed and now VW is buying Porsche. The outcome is that Porsche’s emissions will be based on the average of the VW group. Ford (140 CO_2 g/km) had responsibility for Aston Martin, Jaguar, Volvo and LandRover. Its recent divestments of the last three could be related to emissions.

The structure of the car industry, then, continues to alter. Despite the view that GM and Ford, back in the 1960s, were to be emulated resulted in British Leyland, Ford, GM and Chrysler shrank in the period 2008-2010. By contrast, in Europe French and German car companies began to work more closely together. Whilst in the process of taking over Porsche, VW also acquired a small shareholding in Suzuki. This would be the twelfth marque to join the VW family. As such both Toyota and VW became larger the GM.

With the rise of Chinese car companies the industry has seen few mergers and acquisitions in spite of suffering some of the worst financial stress in its history in 2008 and 2009. More likely is an increase in the number of global providers. The production structure needs to change to reduce capacity. One stumbling block is ownership.



Founder/ family owners hold stakes in about half the world's carmakers. For example, BMW is 47% controlled by the Quandt family. Hyundia Motors and the Tata group are family controlled. PSA Peugeot-Citroën is controlled by the Peugeot family. Merger will be difficult under these circumstances so Peugeot-Citroën has been pursuing partnerships. A broader alliance with cross-shareholdings with Mitsubishi Motors, a company with which it co-operates, collapsed in March amid concerns about the impact on Peugeot's credit rating.

Just-in-Smoke

The idea of Just-In-Time inventory management is found in management and logistics textbooks. It is predicated on hitchless delivery. A major weakness is that it is sensitive to interruptions. Unpredictable events can be costly. In July, Nissan suspended production at its US car plants for three working days as a result of delays in delivery of engine control modules from Hitachi Automotive Systems, which affected about 15,000 cars.

Volcanic ash cloud disrupted airfreight transportation in April. Normally, this would not be an issue for car producers. Although most international freight is transported by sea, 0.5% of UK trade by weight is transported by air. Given its cost, the airfreight is likely to have a high value to weight ratio. By value, airfreight accounts for 25% of UK trade. The lack of key electronics led to the suspension of Nissan's

Cube, Murano SUV because sensors from Ireland were not available. Normally, they are flown in.

Another 'externality' concerned taxi sales. The volcano had hit airline passenger journeys, which would be associated with short distance taxi trips as well. Manganise Bronze, the London black cab manufacturer, claimed the cloud adversely affected the sales of cabs. April sales were down 6% whereas sales for the year to March were up 4%.

Low Cost Markets

Tata Motors, essentially an Indian specialist in trucks plus it unveiled the world's cheapest car, the Nano, in 2008, acquired Jaguar Land Rover for $2.3bn in the same year. Jaguar announced in September that it would rationalise the number of UK plants from 3 to 2 whilst in May it announced that it will assemble units in China. JLR may have to move to India and China, outside the jurisdiction of the EU and US.

GM also announced a new $650m venture with its Chinese partner, SAIC, to sell low cost cars in India. With a 1.7m market in 2008 (up to 3.2m in 2015) and working with China's biggest car producer, GM is shifting focus to the developing world for old technology whilst developing its own products for the developed world.

Mahindra & Mahindra plans on producing ultra cheap mini trucks in India for the home market as well as Europe and US. A diesel version of the Maxximo will be targeted at local but electrical variants will be destined for richer markets.

Industrial Relations

Neelie Kroes was, in January, pressing the French government to explain why pressure was put on Renault to favour French suppliers and not close factories. The French government was considering raising its stake in Renault to 15% or possibly 20%. This followed, the French Industry Minister, Christian Estrosi, informing Renault that the government opposed the relocation of the production of Clio to Turkey in 2013.

The problem of labour market reform in Italy and for FIAT was illustrated at its plant in Pomigiliano, near Naples. FIAT announced it was closing the Termini Imerese factory in Sicily, moving production to Poland. It made of loss of €1,000 on each of the 60,000 Lancia Ypsilons built in Sicily. Unlike the pressures in France

with the production of the Clio, FIAT had considerably latitude with the government. In July, FIAT was facing industrial unrest at the Sicily plant suggesting that the exit costs will not be zero. By contrast, the near idle Pomigiliano D'Arco plant was to expand. The unions at Pomigiliano were told a precondition for this expansion was sweeping changes in working practices. Despite the threat of shifting production out of Italy, in June, the largest of the five unions refused to agree to the changes. This case was closely watched as a test case for industrial relations in Italy. The ballot of 5,300 workers was won by 62% to 36%, but FIAT was looking for an 80% vote in favour.

Where multinationals have a portfolio of production plants spread across the globe, there is a possibility to off-set adverse long term currency movements by shifting production overseas, but this can be undermined. Daimler, in a response to a weak Dollar and cheaper labour, announced that the new generation C-Class was to be based in its Tuscaloosa plant in the US from 2014. 60% of its 273,000 employees but only 25% of sales are based in Germany. Daimler decided to concentrate the production of the C-Class Mercedes in Bremen, shifting some from Sindelfingen. This led to industrial action and, within a month, in December, Daimler conceded and gave employees the assurance that the Sindelfingen plant would not face any compulsory redundancies for 10 years.

This is not the only case of union influence on production. In February, Volkswagen agreed with IG Metal, the car worker's union, a jobs guarantee until 2014. One might suggest the Opel issue will continue to cause GME a headache for some time.

Porsche paid a bonus to its workers in October, a normal practice but out of line with rivals. It was driven to do this by the need to retain key staff. Although the payment was 71% down on 2008, the €1,100 for the 12,500 workers could be viewed as an efficiency wage….

Innovation

The great waves of development in the industrialised world have been analysed by many authors. Some have described Kondratiev or Long Waves. Long waves do not fit within broad macroeconomics as macro is essentially industry-neutral and makes no value-judgement about investment appraisal. With industrial policy, though, things are different. Choices are made about what to protect/ subsidise/ promote. It is most unlikely that policy can cause a long wave but is could facilitate the development of industries based on one. Building on the work of Perez (1983), Tylecote (1991) distinguishes three types of innovation:-

First, enabling technologies present new factors of production that are clearly cheap by existing standards, and are likely to become pervasive. These enabling technologies or *styles* are water, steam transport, steel and electricity, the Fordist style, and microelectronics and biotechnology. When the potential for further productivity growth is exhausted, each is superseded by the next, which Tylecote argued, took around 50 years. The innovation in enabling technologies provides the basis for developments in the other two.

The industries, such as electricity generation, that *make* the new factor should be distinguished from the second type of innovation. These industries *use* the new key factors. Chlorine and aluminium production are examples of industries that could ably exploit electricity generation. This second type of innovation precipitates a third type related to 'new' goods and services. The home computer can be seen as an innovation that exploits one of the technological drivers of the fifth long wave, microelectronics. This, in turn, formed the basis for a third type of innovation, the computer software industry. Products of the third type should have a high-income elasticity in the first instance, but become commodities as their life cycles mature.

The diffusion of a new style is characterised by new labour skills; new products; substantial expenditures on infrastructure projects and, importantly, new patterns of spatial exploitation and hence, competitive advantage. By implication, the competitive advantage of a company or region may be undermined by a change in *technological style* that could lead to the obsolescence of key products and processes.

The Small-Big Beast: Apple

As with the computer, the mobile phone is embedded in the fifth long wave. Although is began life literally as a phone that was portable as opposed to fixed wire, today, with innovation, the mobile smartphone is a minicomputer. It is a second type of innovation, whilst the enabling technology, microelectronics, drove companies to put down fibre-optic cable or mobile phone masts and substations.

In July, the number of mobile phone connections reached 5bn: there were 3.3bn connections (½ the world) in November 2007. This astonishing growth has change the world's capacity connects to each other and to the internet. 10% of connections were to phones in India. Launched in 2007, the iPhone could be viewed as a dominant player in the smartphone market. Whether by accident or design, it is a service provider that vigorously polices its property rights. With its computers, by licence agreement, Apple software is only permitted to run on its hardware. The smartphone market, though, was dominated by Nokia (39%) but consumers believe

that Apple's iPhone and Research in Motion's (RIM) Blackberry are the two products in this field.

Pricing Structure Illustrated

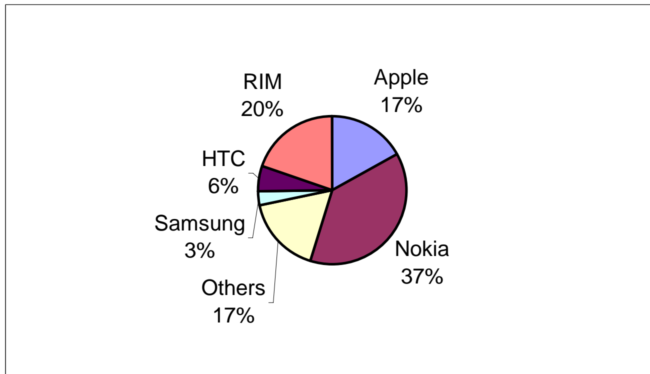
One measure of monopoly position is the margin or mark-up. The absence of competition prevents price being driven down. From an Austrian perspective, the margin is an incentive to innovate and create an improved version of the product. As new generations emerge, in two years, the iPhone has dropped from £599 in 2007 to $99 for a 3G in 2009. The packages provided by phone operators were drifting towards flat fees so that profit was limited. This makes subsidising the phone less profitable. The Chinese launch of the iPhone at the end of 2009 was arranged without the usual revenue sharing model. Instead, China Unicom would pay Apple on a wholesale basis. AT&T has exclusive rights to sell iPhones in the US. Whilst 3GS was sold in the US at $299 with a 2 year contract of $70-$150, Unicom launched the 3G phone at $782. If they sign a two-year contract of over $27/month, customers receive a handset subsidy of $622.

CK Cheng from CLSA suggested that smartphones profit margins in September were 15-20%. Importantly for Nokia, midrange smartphones faced competition from other devices as e-readers and netbooks. Casio-Hitachi and NEC announced, in that month that they were to merge their mobile phone units. In the UK, the 3GS sold for £97 plus a £44 contract. From this, Apple is thought to earn £250 from the provider. This opening up of the market to competition precipitated a price war. It was believed in September that competition would drive the tariff down by £5/month or £120 over a 2-year contract. It costs £350 to recruit 'better value' customer. Vodafone lost 18% of them over 2008/9. Not having access to the Apple would cost Vodafone. Take the AT&T case. It reported Q1 earnings in April. The astonishing revelation was a 65% increase in the number of additional contract clients over the year related to the iPhone. Stripping out cancellations, the iPhone accounted for 174% of the increase in the number of net additional post-paid customers. Smartphones were behind the 52% increase in texting. With this and other uses, revenues were 1.7× greater than standard handsets. This is where the industry believes lies the margin – with high income elastic, low price elastic phones and the services associated with them.

Competition among Smartphones

Two of the largest two producers of mobile phones are Samsung (20%) and LG (10%). LG, though, had just 1% of the smartphone market. The pie chat below

shows Nokia being the smartphone market leader. Market share Q3 2009 put Apple at 17% market share behind RIM and Nokia.



Nokia's N97 was introduced at the same time as iPhone 3GS in June 2009. The latter significantly outsold the former. Nokia's strategy choice of rivalling iPhone not only on ease of use, but more importantly, on what it is used for. Nokia's N-900 was announced in Sept 09, as slimmed down N-97. Nokia is seeking to become a services provider. They have along way to go. The Ovi store, Nokia's bank of applications, contained 4,500 options, when Apple's had 65,000.

At the same time as the Nokia's N-900 was announced, Motorola unveiled the Cliq or Dext, another iPhone rival. This one is notable for being the first Google Android-driven smartphone. It is designed to appeal to Facebook and other social-networking sites. It will be offered by T-Mobile in the US and Orange in the UK and France. Palm got their retaliation in first with the Pre. Launched in the US in June 2009, it was missing features and performance issues that make it less than ideal for professionals.

In November, SonyEricsson unveiled its first Android based phone, Xperia X10, to go on sale in 2010. It has an 8-megapixel camera, a touch screen, GPS and operates with second and third generation mobile networks, including HSPA, as well as wi-fi. Its interface better allows owners to use sites such as Twitter, Facebook as well as e-mail and other messaging applications. It runs on Qualcomm's 1Ghz Snapdragon processor and can use apps from Google or SonyEricsson.

Case Study: Google the Retailer

In May, Google reversed a 5-month strategy of engaging in direct selling of handsets. It reverted back to the more usual reliance on network providers. Perhaps

they were unfortunate in focusing on HTC's Nexus, which did not sell well. Possibly, the marketing power of the network providers, such as AT&T with the iPhone, was too great. Possibly, it should have stuck to its knitting.

Case Study: Nokia Pricing

By June, Nokia was under the cosh. Despite being smartphone market leader at 39% in Q1, it was losing market share. The average price for a Nokia phone was €155 down by €35 from a year before. The market for smartphones had grown by 57% in the quarter and the average Apple iPhone retailed at €475. Nokia even gave away voice guided navigation app (worth possibly $70). The figures to interpret for the quarterly profit and loss are:
1% increase in overall revenues to €10m
8% rise in the volume of mobile device sales.
Profit margins at the unit, which produces the company's handsets:
12.2% in Q2 2009
9.5% in Q2 2010
19% fall in the units underlying operating profits.

The below is not beyond reproach but is an interesting illustration of elasticity and Nokia.
$TR = P \times Q$. Growth has two components, P and Q. Using the relationship, $\left(1+\dot{TR}\right) \cong \left(1+\dot{P}\right)\left(1+\dot{Q}\right)$, where the dot above indicates growth, we can calculate an elasticity. Given a 1% increase in revenue and an 8% rise in volume, price fell by 6.5%. Using
$P\varepsilon D = \dfrac{\%\,\textit{change}\text{ in the quantity demanded}}{\%\,\textit{change}\text{ in the price}}$ we get a price elasticity of demand of 1.23, a price sensitive good. To sell more units, margins and, hence, profitability must fall *ceteris paribus*.

Case Study: Palm Survival

On April 29th Palm, a mobile phone company that develop the market for pocket computing with its Palm Pilot PDAs and Treo smartphones, was taken over by Hewlett-Packard. Superior companies like Apple and RIM had crushed it. Its last hurrah began on 6th June 09 with the launch of Palm Pre smartphone and WebOS operating system aimed at challenging Apple's growing smartphone market share in the US, fuelled by the success of the iPhone and help restore Palm's profitability after two years of losses. On the horizon were competition from Apple's updated iPhone 3GS model and a new BlackBerry,

In fact, the Palm Pre success lasted for a few weeks until the September explosion of smartphones, including new Android-based devices from HTC, Google and Motorola. Profit warnings in March suggested things were not going to plan. Palm admitted a revenue shortfall that reflected the impact of high inventory levels of its Palm Pre and Palm Pixi smartphone products at Sprint Nextel and Verizon. Shipping 960,000 smartphones, it actually sold 408,000 to consumers in the quarter to February, well below the 600,000 units expected by analysts and significantly less than the 8.7m iPhones sold by Apple in the same period. Apple went from 16.6% to 24% market share, whereas BlackBerry contracted from 50.3% to 47.8% from 2008 to 2009. Strategy Analytics estimated that Palm's corresponding share of the US smartphone market fell from 6.5% to 4.2%.

Convergence

From a competition perspective, smartphones are interesting. There was a concern that Microsoft, dominating operating systems and squeezing out rivals should be constrained under a SCP perspective. An Austrian perspective might have claimed this is unnecessary as the consumer benefits from ever-improved products. With products like smartphones e.g. Apple's iPhone and netbooks and most recently the iPad, there is a trend towards convergence.

PC	Laptop Palmtop	iPad, netbook, tablet	Smartphone	Mobile Phone

At one end of the spectrum there is the internet-linked PC, based on the monopolies of Intel (chips) and Microsoft (operating systems). The evolution of mobile handsets from phones to mobile computers has presented rival systems and chips and modes of delivery to the customer, changing the landscape, and importantly, vindicating the Austrian notion that in an innovative sector, the profit motive will break the old monopolies though innovation. With the evolution of phones to mobile phones to mobile computers (smartphones, or tablets), it is now clear that Microsoft did not win an immutable monopoly, and neither did Intel. The software giant was undermined by the change in platform. Now more mobile phones are connected to the internet than PCs. Operating systems that were developed for the phone include Google's Android and Apple's OS are competing with Windows. The chips are different in the mobile phone. De facto Intel (computers) is competing with Arm (mobile phone chips).

The SCP relies on a clearly delineated market so that competition issues can be based on monopoly pricing due to the threat of new entrants overcoming barriers to entry. In a dynamic environment, particularly where convergence is occurring, the

market is not easy to define. Although we associate Apple with innovation (icon based system, iPod, iPhone, iPad) it does not always have first mover advantage. There are discrete elements and yet there are themes running through the products. Its main eReader rival, Amazon's Kindle, had 400,000 eBooks whereas the iPad had at launch only 60,000 and could not utilise Adobe's Flash. Here, Apple's monopoly is based on brand name/ reputation for by-once-buy-well appears to operate.

Operating Systems

Microsoft has been the big beast in the PC-based world, crushing rivals in the market, perhaps in a less than acceptable manner. Through bundling, Microsoft crushed netscape to become the no. 1 browser with 68% of the market. Microsoft has more than 95% and Linux, an open source OS, takes 1.9% of the operation systems market. Although Windows 7 is slow to start up, an important barrier to market entry is that it is pre-installed on most computers, making it difficult to rival. Moreover, Linux has struggled to make accessories such as digital cameras and printers fully compatible with its system. The drive to improve the OS may be hampered by its very nature. As an open source resource, where is the profit motive to improve things? As a public good, the innovation will be consumed for free.

Google developed 'Android', and after 11 months, by August 2010, it was in front of Apple's OS, found many handset makers (LG, Samsung, HTC and Motorola). The next development is Google's Chrome operating system, to be released in 2010. It is a rapid operating system to access the internet quickly, giving it an advantage for running on netbooks, or small portable computers. Chrome will operate on standard x86 chips (that power most computers) but also Arm-based chips (used in 95% of mobile phones), as well as in set-top boxes. This is a versatile system, based on Linux. Chrome may be an important step forward. As internet applications running inside a browser become more complex, speed of running Javascript has become a central issue in making the web perform more effectively. Encryption can operate within a browser, removing the necessity of a PC being part of the authentication process, which would threaten not only Microsoft's but also social websites, such as Facebook's, base. In September, Google announced an alliance with Sony's PC division that entails pre-installing Chrome on new Vaio PCs, is the first the internet company has struck with a computer maker, overcoming a barrier to entry. Some software companies, such as Adobe, adapted their software to run on Arm as well as the Intel chip. The Windows operating system will not run on an Arm device, which was a major stumbling block or a barrier to entry allowing Chrome to become a significant alternative to Windows.

Chips

Computer chips, which are faster and more powerful than mobile phone microprocessors, consume far more power so keeping the markets for these chips and the software architecture designed for them separate. Cambridge-based, Arm mobile phone semiconductors, produce an applications chip used in smartphones that costs $15-20, providing Arm with 15-20c. At the computer trade show in Taiwan in July, Arm chip-based netbooks were unveiled.

As a manifestation of convergence, Intel developed the Atom, a much smaller, more power-efficient chip, which is used in a number of netbooks. Atom chips are nearly twice as fast but Arm chips use ¼ of the power consumption. In June 2009, Intel announced a strategic partnership with Nokia research into products that would be a hybrid of a smartphone and a laptop. Intel aims to produce a mobile phone chip by 2011.

Third Type of Innovation

The iPhone appears to have put the rest of us on a new path of consumption and create a new industry on its own – a third type of innovation. The iPhone '*app*lication' industry emerged as Apple relinquished its grip on the applications that could be uploaded. This one act, allowing other innovators to create new products and share earnings with Apple, fostered a new industry and new millionaires. By the end of May, 5bn apps had been downloaded from its apps store. Perhaps correspondingly, Apple only spends 3% of revenues on R&D, whereas Nokia spends 10%. The management of the process is most impressive. Apple manages to make money out of downloads whereas the music industry's International Federation of the Photography Industry claims that 95% of all music downloads are illegal.

As Austrian economists would predict, copycats emerged. In 2009, Vodafone launched an open platform that permits any developer to market applications that can be downloaded on to mobile phones. Vodafone 360 will be available on 6 handsets made for them from Samsung, Nokia and Sony and was introduced to take some of the iPhone market. The idea was that Vodafone did not to be just a network (dumb-tube) provider. However, Ender Analysis suggested this was a 'futile' strategy. It should concentrate on customers with basic handsets. 75% of their revenues come from charging access to the wireless internet.

Vodafone's CEO, Vittorio Colao, believed that not having rights to sell the iPhone cost his company 159,000 customers in the Q3 2009. Interestingly, O_2 lost its UK

exclusivity deal in August 2009 to Orange and then, in the same week (last in September), to Vodafone which added rivalry, but not until January in the latter's case.

NTT DoCoMo indicated in July that it would offer its own apps store for its in-house i-mode mobile phones. Until then, it relied on browser services. This appears to be a reaction to Softbank, its Apple linked Japanese rival, which increased in market share on the back of iPhone4 and iPad. A criticism of this strategy was that consumers may appreciate that apps so much that they drift to Apple.

Another Revolution on the Horizon

The eReader/ eBook/ tablet/ iPad presents a possibility to revolutionise publishing. Amazon has been striking deals directly with authors, cutting out the intermediary, the agent. Stephen King has written books specifically for eReaders. Sales of eBooks increased by 200% in the year to May when they fell for books by 7%. Amazon now sells more eBooks than books. A concern, that has yet to materialise, was that Amazon would dominate publishing and royalties. But the future for the printed word, given the ubiquity of the Apple influence on our way of life, is likely to be electronic. Andrew Wylie, a literary agent, in July, signed a deal with Amazon to allow online selling of 20 classics written by authors such as Nabokov and Updike. The CEO of Penguin, John Makinson argued that eReaders and the new media will change things in the following ways:

- ❑ The growth of book sales has always been driven by new outlets, such as supermarkets;
- ❑ eBooks can be augmented by audio, video and gaming aspects utilised, but possibly not exploited fully by the current book industry;
- ❑ On-line communities/ social networks could contribute content and guide the creation of future author's work.

Innovations are commonly supply driven, but exploited when consumers can see something special about them. Given the extraordinary interest in mobile phones and social networking a new form of consuming the written word, in a more social/interactive way, seems a certain development.

In August, another iPad dimension made the news. The iPod was a success, partly because of content, the access to music. The iPad has two weaknesses that Motorola decided to exploit: first, it does not use Flash, but HTML 5; and second, there is no killer content link. The obvious content link, which Steve Jobs attempted, but failed, to secure is access to pay-to-view TV. Working with Verizon, which has a 25% of the US TV market, Motorola is to develop a tablet that shows TV, with two cameras and run on Android.

Web Economics

Another casually of the credit crisis was the internet model used by many internet websites. For the end user much of the internet use is free. A generation of free riders, perhaps knowing no difference, are not used to paying for access to information. A sizeable proportion of the costs are borne by the advertiser. It was presumed that access to uses by providers would allow them to sell advertising rights and so provide the content free. As advertising revenues began to dry-up, providers began to sell what had previously been offered free of charge. Expensive journalism could not survive giving away comment for free. The Financial Times and the Times are examples where access to on-line copy requires a regular subscription. This issue is still in the melting pot.

Networking – Another 3rd Type

The pace of change is such that new business models need to emerge before the old ones have had their day. As discussed above, giving information away for free is uneconomic. If advertising revenues do not pay for the service, internal internet barriers emerge. These alter the power of search engines. Before such firewalls, a key internet money-spinner was the browser. Yahoo, AOL, Netscape, Explorer and then Google became dominant. Then, the advertisers were interested in product-search, and web-site hits. Now, the information that advertisers want is hidden behind walls of privacy. Social websites are prominent on both mobile phones and computers. As in marketing, knowing your market is vital to target advertising. PC and mobile phone companies are seeking to tap into the networking revolution that has emerged and manifests itself as websites, such as YouTube and Facebook. If users reveal their location, with whom they spend their time, and their consumption patterns, this presents something to sell to advertisers. Indeed, in September, Facebook announced a partnership with Nielsen, a market research consultancy. This clearly marked out what Facebook believed it could exploit of its millions of users.

Burberry, the fashion clothes producer, launched artofthetrench.com, a website to exploit its 600,000 fans on Facebook. Wanting to tap the networking potential of such a base, it join Asda and Sears as companies seeking to converse with its customers. Pepsi announced a $20m marketing campaign in January. Moving from the Super Bowl to Facebook, this appeared to signal a shift in thinking about branding from peripheral to core. This is partly related to the flexibility displayed by Facebook, which markets itself to potential clients pointing out its reach.

Networking Market Share and Growth

By October 2009, the market for networking media was vast. Facebook had 430.2m unique visitors aged 15+ with 350m active users. The average user, with 130 friends, spent 55 minutes/day sharing 1.47 pieces of content. MySpace had 110m users in and Twitter 58.3m according to ComScore. By July, Facebook claimed 500m members. In 5½ months, 100m additional members had been signed up. Google had 932m monthly visitors, Microsoft 789m and Yahoo 633m. According to ComScore 80% of the UK and 67% of the US population had accessed Facebook.

Another alliance with Facebook, announced in February, was Paypal. Facebook is a platform for social games, which generate significant sum and, in addition, some retail opportunities. Paypal can be used to buy Facebook Credits, the virtual currency, which, in turn, can buy goods from Sears and BestBuy. In June, Facebook's CEO, Mark Zuckerberg, at Cannes, met the world's advertisers. The advertisers were very keen to understand the benefits of social media and social media want to win over marketers. This is the next battle, making money out of social networks. Both were grappling with the shift from search engines, and knowing how to best exploit the situation, particularly given the privacy issues faced this year.

By April, Google, Twitter and Apple were grappling with platforms for raising advertising revenues. Apple announced yet another product, iAd. This is a facility of placing adverts inside apps so they do not have to be left to see the ad. Like the apps themselves, they can be made by third parties with the revenues shared 3:2 in favour of the developer. This was in competition with Google, also attempting to pop ads in mobile devices. Twitter was also looking to sell advertising space on its system. But, as discussed below, the information about customers is more difficult to extract without upsetting those customers in the process.

Ignored Privacy

Facebook was facing privacy restrictions. The Federal Trade Commission was investigating the increasingly blurred line between private and public information where Facebook was criticised for not protecting its users sufficiently. By May, Facebook was forced into simplifying its privacy controls. The levels of friends, friends of friends, and everyone, applied to all the actions. The default position was that information was closed to private unless permission was given to reduce the degree of privacies. The fear was that Facebook, in the pursuit of profit, was pushing the boundaries of data protection laws. By contrast, following the unveiling of its

own advertising platform, Twitter banned adverts on Tweets. This appeared to have been welcomed by users.

Network Strains

In September, France Telecom and Deutsche Telekom announced a joint venture whereby their mobile subsidiaries, Orange and T-Mobile, are to be merged, potentially reducing costs by £3.5bn. The entity will comprise the third and fourth largest internet providers in the UK will jump to be the largest, leaping Vodafone and Telefonica's O_2. The new firm would have 36% of the market with O_2 at 28% and Vodafone at 25%. With a monopoly position, it is appropriate to look at margins. Orange's profit margin in the first half of 2009 was 19.6% and O_2 was 25%. Size and margin seem related. According to Tom Alexander, head of Orange, one aim is to get consumers to buy more expensive handsets that surf the web and they then buy content. Interestingly, in September 2009, he claimed that as a result of the merger the price of a call would not rise. Of course, other elements in the mobile phone package could increase. To achieve regulatory approval they were asked to give up some of the frequency band at 1800 mHz. They thought this was unreasonable. By December, a group of rivals were pushing for a review from regulators in the UK rather than Brussels, possibly because the process would be longer.

On 1st March European Commission approved the merger to start trading in April - on the fastest possible timetable. The decision is contingent upon an infrastructure-sharing agreement with 3, the UK's smallest network operator, primarily to prevent predatory activity and to relinquishing up to 25% of the 1800 frequency band suitable for 4G phones. Once the disposal was clear, Vodafone and O_2 were keen to know whether it would be sold as one lot for the two of them, causing a bidding war, leaving the loser out in the cold.

Having such a large margin in one market, it is ironic that Google became the subject of much angst for them. Those investors enabling the mobile smartphone revolution, the internet network providers, in April, pointed out that the broadband-hungry users were not sharing the advertising revenues fairly. Telefónica and France and Deutsche Telecoms felt that Google should start paying them for carrying relatively expensive content, such as YouTube. The customer demanded ever quicker and more sophisticated services that rely on more expensive and sophisticated networks – costing billions to lay down. The Google approach made them 'dumb tube' providers and Google creamed off the advertising revenues. Sadly, the network providers sell their services to the customer on the basis of what services can be sent down them. Without Google-type services, customers would not

be that interested in the high-speed service on offer. Clearly, there is a symbiotic relationship between them but the weight is too much in the services' favour. AT&T estimated that it took until the 17th of a 24-month iPhone contract to break-even. But, in June, following AT&T, O_2 scrapped its all-you-can-eat charging structure, introducing a cap for daily data usage.

Although not discussed. An issue on the future will be the neutrality of the network. Google could easily favour its own or associated product through its search engine, which would constitute a monopoly practice.

Console

The introduction of Sony's PS3 Slim in August 2009 sparked a price war of sorts. The expensive PS3 retailing at around £299 competed with Microsoft's Xbox 360 (21% market share) and Nintendo's Wii (49%). The Slim was introduced at £85 less. A week later, the Xbox was reduced by £30. Nintendo did follow suit in late September, returning the US differential with the PS3 to $100. Interestingly, Sony also unveiled online applications and Microsoft is planned to link the Xbox with Facebook. The price following the competition was downwards. The PS2 was, in 2000, £299; in Sept 2001, £199; and in September 2002, £169. 80% of the 10m sales were at the lowest price. Computer games have a higher margin than consoles so retailers prefer them. Sell them the console at a loss and make money from the games.

Competition Policy Issues

In June, EC ruled that BT should share its broadband network with rivals. The former competition and now the telecoms commissioner, Neelie Kroes, accepted an Ofcom ruling of only a partial opening, but this is an interim stage. Although this makes sense on a CMT basis, Ian Watt, from Enders Analysis, question its wisdom. BT could not yet unbundle the broadband to make it available.

Ofcom ordered that mobile phone companies should reduce their termination charges. Such a charge is made when crossing from one network to another. A BT landline user is charged the equivalent of 4.7p/minute for calling a mobile phone. Ofcom wants this reduced to 0.5p by 2015. This represents a cost to phone companies of £800m or £15/month per mobile phone user.

Sky – the Supplier

Following an Ofcom investigation in to the pay-TV industry, in March, it ruled that Sky should reduce the wholesale prices it charges its rivals to show its sports channels. Sky's wholesale prices for Sports 1 and 2 would fall to £10.63 a month each (23.4% reduction); combined the new charge of £17.14 is a 10.5% drop. Also, Sky should offer its HD sports channels to competitors. Ofcom lacked the power to compel Hollywood studios to sell pay-for-view films to others other than Sky and so asked the Competition Commission to do so.

The Rugby Football Union CEO, Francis Baron, complained that: "Ofcom's proposed approach effectively confiscates our rights and donates them to organisations who have consistently declined to invest in sports rights despite having balance sheets that dwarf Sky's." The Football Premier League was not supportive of the Ofcom ruling either complaining that the decision will reduce the bids for its services.

Following complaints from BT and Virgin in 2007 about Sky's 85% market stranglehold, Ofcom is opened the door on greater choice. BT and Virgin could offer rival deals for packages of broadband, telephony and TV that includes sport, or Freeview sport and films on demand could grow. One could argue that by opening access and reducing price to other providers, it is making Sky's markets more contestable. Strange adverts appeared on Sky about Sky supplying the best coverage of Sky products.

System Competition

In *Update 08*, there was a discussion of system competition, first mover advantage, and winner-takes-all adoption. Sony and Toshiba were rivals. The format that won was the winner based on adoption and content not quality. Within a day of Wal-Mart announcing that it would only sell the Blu-ray system, Toshiba decided to stop the production of HD-DVD players. In mobile phones, optional extras are the key: Apps. On top of Apple, Google, Nokia and Vodafone, others have gone down the apps route. Sony announced a new strategy in November called Sony Online Services. The aim is to encourage software developers to use Sony hardware as a platform for delivering movies games and music to customers. As with mobile phones, the downloadable 'apps' are seen as essential. One vision entails buying a film via SOS and then, through a logging in process, be able to watch it on a variety of facilities, such as a mobile phone. Sony would charge for storing this data.

In its reader war with Amazon's Kinder, Sony also managed to form alliances with 19 content providers in December. This list includes the NYTimes. Amazon has ties with a string of rivals. In a copying of style, Audi announced, in May, a relaunch of the A2 city model but with 'apps' that can be downloaded to customise the car.

Competition in the Electronic Services Market

The current situation does not lend itself to one format being dominant. The network providers, normally the group with the monopoly position, are complaining about being ripped off: they subsidise the sales of phones. AT&T has exclusivity agreement to sell Apple, but that does not apply in the UK. Apple has only a small proportion of the market. There are several operating systems (iOS, Android, Windows Phone 7, Symbian). So far, the switch from Microsoft to Apple as the big beast is not a concern: Apple appears more like a niché player. Consumers clearly want it. 1.7m iPhone4s were sold in the first 3 days and 3m in 3 weeks from launch. If, however, it shifts to a basic necessity of life, like a TV or internet linked computer appears to be, then regulators will be interested.

One might suggest the convergence might lead to a frenzy of copy-cat moves, mergers and alliances as a model of securing access to the customer and selling them 'content' is the model. Moreover, could it be that rather than the home entertainment model, it is the mobile entertainment model that is the killer product? Intervention by competition authorities seems completely inappropriate. As with Microsoft, Apple, the new beast, will be beaten by innovation. The winner, though, will be the consumer.

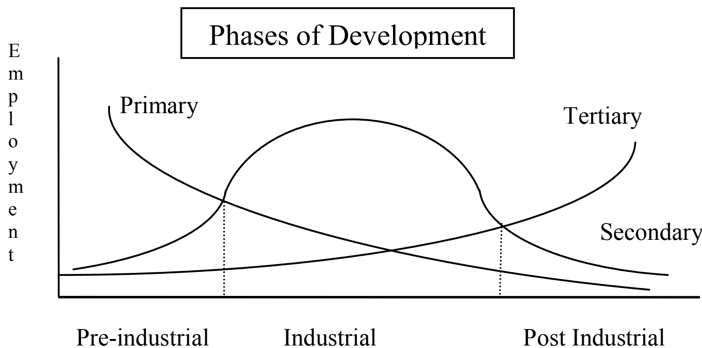
Deindustrialisation or Restructuring

UK deindustrialization continued as its proportion of total value-added slipped in 2009 to 2.6% of global manufactures or $227bn. This meant, according to HIS Global Insight that the UK was 7th largest producer of manufactures in the world. In 1980, the proportion of UK manufacturing in the world was 5.4% and in 2006 it was 3.6%. The shift from the secondary to the tertiary phase results from productivity growth in manufacturing and services having a higher income elasticity. To put it his into a context featuring issues in the *Update*, this can be seen within the mobile phone industry (above). The mobile phone is a commodity and the smartphone is where the profit is. The making of the unit does not generate the profit (see Foxconn), it is the R&D and the apps that produce high returns.

To illustrate the means by which productivity can free up resources to move on to the next phase of development, consider the farm tractor. Over the 20th century the

tractor and other sophisticated pieces of kit were gradually replacing man and horse. The work done by 50 men and women and several horses at the beginning of the century could be done by a handful of men and women with tractors at the end. Output per person grew substantially. Technology has allowed productivity to increase further. With an accuracy of up to 2cm, farmers can now farm by sat-nav. The accuracy is greater than humans can achieve and can avoid the waste of overlapping applications of seeds etc.. According to the Agricultural and Horticultural Development Board, the net benefit of operating such a system for a typical 300htr arable farm was around £6/htr; for a 500htr, £10/htr; and for 750htr, £19/htr. Moreover, as this is not dependent on sunlight, the working day can now be 24 hours; potentially a substantial productivity increase.

The Fisher/Clark thesis posits that manufactures can grow independent of agriculture and services can grow independent of manufactures. Hence, the decline (deindustrialisation) may not be that significant. Page and Walker (1991) argue that the development of the car industry in the American mid-west was based on a symbiotic relationship between agriculture and manufacturing. The machinery that led to a motor vehicle industry also powered the productivity growth in farming, providing the market for motorised farming vehicle. The same symbiosis is emerging in services. Siemens illustrate this. In March, the CEO, Peter Löscher, claimed that, to maintain a lead over US and Asia, the European economy depends on shifting from industrial companies pushing in to services. This is not giving up on manufacturing. Rather shifting to highly complex and specific services that support manufacturing is where the money is.



This manufacture-service link is becoming widely recognised. According to Bain & Co. the consultants, the shift towards services is high on the agenda of 81% of

German-zone engineering companies. The head of the European Roundtable of Industrialists (ERT), the CEO of Volvo Trucks, Leif Johansson, railed against the outsourcing model of the multinational in Europe. He argued at the annual plenary in the ERT in June that the model of retaining R&D in Europe whilst manufacture takes place elsewhere is flawed; the two go hand-in-hand.

This outsourcing of production comes at a price. High costs and exchange rates had led to outsourcing to Asia and Eastern Europe. Despite European brands making up 75% of the global luxury market, according to Boston Consulting Group, industrial bodies in various countries report that the number of skilled craftspeople is dwindling.

At the end of March, both Sony and Toshiba announced that they were selling production plants to rivals from Taiwan. Sony's goal of increasing profits has seen it divest itself of over a quarter of its 57 plants since December 2008. The most recent, a TV assembly plant in Slovakia, was only opened in 2007. Toshiba disposed of a unit that manufactures small liquid crystal displays in Singapore. Both divestures suggest that, even with low cost locations, the Japanese cannot compete with the economies of scale the Taiwanese enjoy. A small Spanish TV plant that Sony retains is likely to follow suit.

Perhaps paradoxically, Sony still aims to increase TV sales from 15m to 25m within two years. Having sold the plant in Slovakia, it is even more reliant on outsourcing to the company that bought the facility, Hon Hai. Interestingly, Hon Hai has secured control over the supply of liquid crystal panels necessary for TV production and can exploit economies of scale to lower costs. Thus, with Hon Hai, Sony's drive to increase sales does not seem so strange.

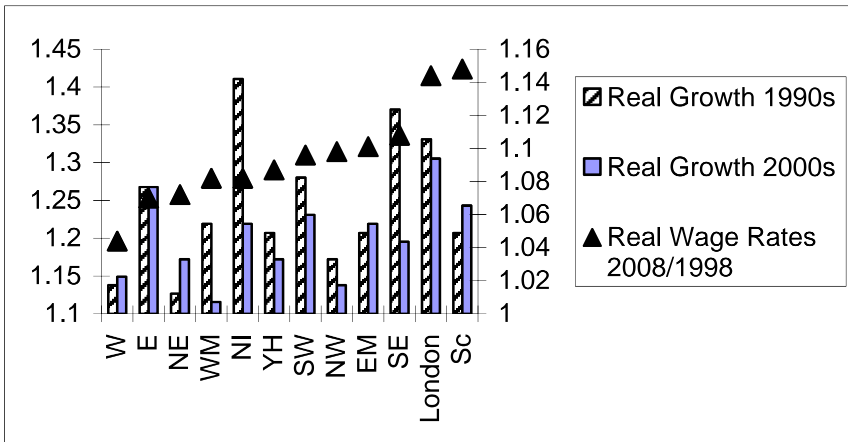
The low cost products are made in countries like China and are sold worldwide. These then generate service jobs, ranging from maintenance and upkeep to operating equipment. Many industrial companies have more than 50% of their workforce in non-manufacturing posts. Kone, the Finish lift-maker, earns half its revenues from services and 30%-40% of revenues from Siemens' Healthcare and Energy are in services. Bain estimate that services are four times more profitable than simple production. They also tend to be less cyclical. However, a key variable is long term association. The buyer is drawn closer to the supplier, providing scope for differentiation between suppliers.

As a contrast, Panasonic announced a strategy of producing cheaper white goods in the markets they are aimed for. The $170 fridge for the $2,500/yr Indonesian earner is to be designed and built there. This is a relatively poor customer compared with

their more affluent $5,000 target. This consumer needs room for water that has been collected from a pump and boiled. The fridge is to be branded locally and distributed separately from Panasonic labelled goods. Other Japanese companies outsource low-end white goods manufacture whilst concentrating on on-line services to differentiate themselves.

UK Restructuring

As the decade ended, it provided an opportunity to review regional and industrial performance. The graph below shows real wage growth for the 10 years to 2008. It also shows GVA for the 1990s and, assuming the average annual growth rate from 2000-2008 is maintained for an additional year, for the 2000s. Real wage growth (right-hand scale) does not reflect output growth well. Scotland (14.8%) has the highest and Eastern (7%) one of the lowest rates of increase. But then London (14.4%) is second and Wales (4.4%) is last in the pecking order, with a full 10 percentage points between them. The so-called north-south divide emerges clearly with GVA. GVA grew by 33% in the 1990s and 30% in the 2000s in London but only 24% and 18% respectively, for the UK. The West Midlands's growth rate halved from 21% to 11%, whereas the East Midlands grew more quickly in the later period. The North East and West along with Wales and Yorkshire Humberside grew more slowly, with Wales growing by 13% and 14%. Northern Ireland is the surprise winner. Although a traditional peripheral region, it benefited from the ending of the troubles.



Manufacturing output grew by 0.6% on an annual average basis in the 1990s but fell in the 2000s by average of 1.2%. Services grew at an annual rate of 3% in the 1990s and 2.6% in the 2000s. Manufacturing's woeful performance can be seen in the

pattern over past decades. In the 1960s, manufacturing output grew by 3.1%; 1970s 0.6% and in 1980s 1%.

PwC reported in February that HQs of the FTSE350 were moving south. Between 2000 and 2009, the proportion in the north of the UK fell from 51.1% to 42%; London seeing an increase from 38.1% to 41.1%. Foreign ownership grew from 0% to 7.2%. The report pointed to other headquarters; professional services e.g. marketing staff; and bankers for M&A as drivers. Indeed, the drawing on experienced non-executives will pull the company HQ to London. For example, Vodafone is moving its HQ from Newbury to Paddington, so that executives could be closer to their business partners and shareholders.

Wales – a Peripheral Region

In *Update 08*, NIDL was discussed in relation to the North East. It predicts that the low value-added activities commonly associated with mass production assembly processes, will move to low cost areas. These plants, in any restructuring, will be shut down with little concern for the local community. The North East has a predictably sad recent record. Wales suffers from this problem also. In January, Bosch announced it would close its car parts factory in Cardiff costing 900 jobs. This is but one of a number since Welsh devolution. Below is a table showing the major investors since 1997. The predominance is the Call Centre, the service sector equivalent of the low skilled factory assembly work. With a history of high unemployment from the great depression to the 1990s, its unemployment rate of 8.5% reflects a return to above average unemployment. GVA/head in 2008 was £15,237, 74.3% of the UK average and 44% of that of London, the core region.

Type	Firm	Jobs
Call Centre	118UK	1400
Warehouse	Amazon	1200
Call Centre	Cable&Wireless	1017
Sales	Wilkinson Hardware	829
Call Centre	One2one	810
Call Centre	BT	662
Power Station	Siemens	620

The North East – An Innovative Peripheral Region

Against NIDL predictions, identified by the British Library, the North East is as a centre of innovativeness. As the depository of patents, the Library reported that 25,000 patents/yr were lodged since 2000. The North East had the same registration

of patent/trademark per head rate as London, the most active by number. However, with ⅓ of the population and ¼ of the R&D investment, the North East over achieves on the British Library index.

The Contribution of Rolls-Royce

The impact of Rolls-Royce on the British economy for 2009 was estimated, by Oxford Economics as £7.8bn. This is 5% of the manufacturing output (£155bn) of the UK. The breakdown of the contribution to the economy (GVA and GVA/head) was estimated as follows:

	Contribution	Contribution/ head	Employees
Direct Employment	£1.6bn	£76,500	21,000
Indirect Employment	£1.8bn	£40,100	44,000
Induced Employment	£1bn		
Technological Spillover	£3.4bn		

Income multipliers were discussed in *Update 09*. The induced contribution, based on spending of directly and indirectly employed workers, suggests a multiplier of 1.3. Assume every job gained in the supply chain, worth £40,100 and:
£10,100 goes on profits and employment taxes; £5,000 reduction of benefits;
The job associated with RR will lead to a rise in induced expenditure of (£30,000 – £5,000) × 0.3 = £7,500. Thus, an extra 4 employees in the RR supply chain will induce an additional £25,000 spending, which could bring about another job in the wider economy.

More important, perhaps, is the technological spillover. This is where technological advances lead to developments in RR and other companies, increasing future potential output. In new regional theories, technological spillover is an important growth-inducing factor. Note, the figure of £3.4bn is based on what was accumulated over 20 years, which gives an inflated value.

Microeconomics

The Price of Drink

A concern this year was the use, by supermarkets, of cheap alcohol as a lost leader and the impact on alcoholism. With a normal demand curve, a higher price should induce less consumption. Of course, the elasticity of the good means that sensitivity to price will not always be that great, as in the case of addictive goods. However, when it is priced *too* cheaply, more alcohol can be consumed for a given amount that

could push some towards alcoholism. Doubling the price from a very low level will not affect consumption of the new alcoholic.

The House of Commons health select committee reported in January that a minimum of 50p/unit of alcohol would save 3,000 lives a year in England. Sheffield University suggested that than minimum 40p/unit in Scotland could save the Scottish economy £950m and prevent 3,700 deaths over 10 years. This increase would cost a moderate drinker £11 and a heavy £137/year. Despite the obvious logic, retail groups, such as the British Retail Consortium and drinks industry representatives found reason to criticise. SABMiller cited evidence that 80% of men and 90% of women drank moderately. The BRC suggested changing the culture would be better than price. Interestingly, the low cost alcohol is provided by supermarket through their own-brands. This debate seems to mirror traffic lights and the unwillingness of the supermarkets to inform customers. The supermarkets' pricing was highlighted in December when it was reported in the Sunday Times that (bottled) water was more expensive than alcohol. Tesco and Sainsbury's were offering Highland Spring Water at 8.5p/ 100ml but Tesco's value cider was 6.1p and Sainsbury's basic bitter was 5.3p/ 100ml.

In February, the Dept. of Health reported that five out of six drinks companies failed to adhere to a voluntary code carrying statements about the risks of excess alcohol consumption. It is estimated that alcohol abuse costs the NHS £2.7bn annually. The number of alcohol related deaths in 2008 is 9,000, almost 3 times the number in 1984 and that 22,000/year premature deaths occur because of alcohol abuse.

Oldham followed Scotland in placing restrictions on vendors, including supermarkets, on pricing over the Christmas period. Supermarkets could only display cheap alcohol in restricted, patrolled zones, out of limits to under-18s. Bars could only sell 2 units to a customer per bar visit at below 75p/ unit and then the bar had to employ an extra bouncer.

Income Elasticity

As reported in *Update 09* upmarket goods suffered during the prolonged recession. Last year, champagne sales contracted by 30%: much more quickly than sparkling wine, its cheaper substitute. In January, champagne prices were cut to less than €10 a bottle from possibly over €100s. On discount were Grand Siele (€10), Jeanmaire (€13), Humbert de Clampinger (€8.90) and Paul Breteuil (€10). Red Lobster, in New England, was on sale for $4.99/lb. So far had prices fallen that mainstream restaurants, such as Ruby Tuesday, could afford to put it on the menu.

The Price of a McDonald's

Recognising its produce as income sensitive, in the face of high unemployment, McDonald's reduced its prices in Q2 in the US. The price of 'the basket' fell by 6%. The outcome was a 3.7% rise in sales (revenue) as a result. Using $TR = P \times Q$. Growth has two components, P and Q. Using the relationship, $\left(1+\dot{TR}\right) \cong \left(1+\dot{P}\right)\left(1+\dot{Q}\right)$, where the dot above indicates growth, we can calculate an elasticity. Given a 3.7% increase in revenue and a 6% decrease in price, volume increased by 10%. Using $P\varepsilon D = \frac{\%\, change \text{ in the quantity demanded}}{\%\, change \text{ in the price}}$ we get a price elasticity of demand of 1.72, a price sensitive good. For greater revenue, price must fall *ceteris paribus*. [Of course income fell as well which could, in theory, reduce (normal) or increase (inferior) demand].

The Price of Weight

A diet for men that has recently crossed the pond from the US and delivered by Weight Wins, is based on financial incentives. For a joining fee of £90 and a monthly fee of £20, participants are rewarded financially for losing weight. Setting their own targets bonuses are awarded for goal achievement and payment is made per pound.

Substituting in capital for labour is possible even in some areas where we expect human interaction. Progressively, throughout the era of self-service the supermarket has reduced human contact. Tesco, in its Metro stores, like elsewhere in the sector, uses self-checkout tills. However, in the Liverpool Street Station branch, 20 of their 42 isles are unmanned. Tesco aims to extent this idea so that almost half of its stores will have self-service tills; in 2008, it was only 30%. In 2007, Tesco customers used self-service tills at a rate of 5m/week; by 2009, this increased to 6.5m. Sainsbury aims for 2,000 self-service tills by 2010, up from 514 at the end of 2008. Across the sector, there were 7,000 self-service tills in 2008; by 2011 there will be 15,000. Verdict suggests this is driven by profit: it increases through-put and lowers labour costs.

Monopoly Practice

In September, six recruitment agencies were fined £39m by the OFT for engaging in collusive activity and price fixing. As is common, the whistle blowers in 2005 (Beresford Blake Thomas and Hill McGlynn) were exempt. The six met 5 times to agree not to work with a rival/ intermediary in the construction labour market and to

arrange fees to charge to intermediaries. Hays was fined £30.36m alone. This followed a decision, reported in *Update 09*, a week earlier, to fine 103 construction companies £129.5m for price fixing.

Desirable Outcome?

In a liberal democracy/neo-classical economics the individual is the best judge of their own utility. There are areas where individuals are not that good at making these judgements. These are viewed as areas of market failure. Demerit goods, in particular cigarettes have been targets by the government, partly to reduce the burden on the NHS. Paradoxically, cigarette companies, Imperial Tobacco (£112.3m) and Gallaher (£50.4m) plus Shell, First Quench, Morrisons, Safeway, The Co-operative, Somerfield, Asda, TM Retail, and One Stop Stores, in April, were fined by the OFT for collusion. The concern was that, having 90% market share, the cigarette companies were exploiting the consumer. However, in their defence, they claimed they worked with the supermarkets to ensure that the brands were not undermined by excessive price competition whilst still allowing for promotions. The aim is to stop collusion, bringing down prices, encouraging smoking???

Child smoking in Indonesia came to international attention in June when a two year old, Ardi Razal, smoking up to 2 packs a day since he was 18 months was featured in news items. Around 1.8% of the 60m smokers in Indonesia were between 5 and 9-years-old. Indonesian cigarettes are among the cheapest in the world.

The fall in US cigarette consumption in 2009 following a 25% price increase was 8%, which give a price elasticity of demand of –0.34. This is inline with the inflation adjusted price increase of 87% between 1969 and 2009 leading to consumption to fall by ⅓, which gives a similar coefficient (–0.37), clearly a product to tax. Indeed, 60% of the ticket price is tax. UBS assesses that retail prices can increase by 8 to 9% annually causing a 4 to 5% reduction in consumption over the next decade.

Unforeseen Penalty

An interesting twist in a cartel story is the possibility of directors involved in the cartel being sued. Morrisons, the now owner of Safeways, went to the High Court to recoup fines on Safeways dairy product cartel activities from former executives. Bizarrely, the former chairman believed this unjust.

A strange twist in the tail of European fines was the complaint that the fines were disproportionally harsh. Three record fines were reported in *Update 09*. However, a week after being given a €19.5m ($28.7m) fine by the European Commission, one of

the largest chemicals manufacturers in Slovakia, Novacke Chemicke Zavdy (NCHZ), filed for protection from its creditors. The chairman, Miroslav Suba, claimed: “The drastic level of the fine came as a surprise to us...” and “We believe that, in line with European principles, the Commission should act in a manner that will ensure that its decisions are not ruinous.” It is anticipated that fines may be measured in line with the capability of paying.

A variant on the disproportionality point concerns succeeding court cases following being found guilty of operating a cartel. BA in July was trying to spread the pain at High Court. Along with others BA operated a cartel over cargo prices. Having paid US and UK fines the case was not closed. In July, two UK flower importers were to sue BA for losses suffered. This class action approach is interesting in the UK. In a sense, authorities need not fine companies. Just providing the basis for a class action can make returns from the cartel questionable. Also, as with the building trade, loss of reputation may lead to being excluded from future tenders.

Nine chip manufacturers accepted a fast track fine in May of €331m. From 1998-2002 they conspired to coordinate price offered to computer manufacturers. This is the first EU fast-tracking case. Microsoft was ordered to pay over $290m (£175m) for infringing wilfully a 1998 patent of XML, owned by i4i, a Canadian firm. Later, it was banned from selling Word.

17 bathroom fittings companies were fined a total of €622m for a 12-year cartel running from 1992, including Grohe of Germany.

Leading Gas Light

Energy companies are often accused of using their oligopolistic position and extracting rent. They are seen often as claiming to pay attention to two measures, the spot price and the future price of energy, selectively. BG announced a cut and later the others followed suit within five days of each other, posting a cut of 4-8%. Last year the same thing happened, but this a cut of 3-9%. The price changes for the other five in both years came into effect at the end of the month. In 2008, the five raised their prices by between 13 and 17% within a month of each other. Consumer Focus, which represents gas and electricity customers, raised concerns about the big six not engaging in price competition, with five just following what British Gas does, resembling a leading or barometric system.

Water Costs

The average unmetered water consumption per head is 150ltrs and 127 when metered. This could suggest that the unit-use based contract provides incentives to be economical with water. Typical costs of household uses of water are: bath (80ltrs), 15p; lavatory flush, 1.5p; washing machine, 12p; and dishwasher, 5p.

The South East, being so densely populated, has less rainfall/ head than Syria and the Sudan i.e. desert countries. The privatisation of the water industry was supposed to lead to a large capital investment programme. The companies were denationalised at ¾ of their market values and, with subsidies, investment programmes were anticipated. They did not happen. Instead profits and pay rose. Each day, 750mltrs are lost due to leaks. In London, 60% is lost to leaks.

More or Less Water Pressure?

From an economic point of view, if the benefits outweigh the costs of a crime, the crime might make sense. This may explain why UK water utility companies, which faced an average fine of £4,411 over the period 2004-8 for each serious pollution offence, clocked up 342 of all industries' 1,500 such breaches. The fines are too insipid.

A solution to a leakage problem you would have thought would have been to repair the leak. The penalty of a leak at home could be a soggy carpet, but for a water company, it is a fine from the regulator, Ofwat. Seven Trent and Southern Water, fined over £70m for poor leakage management engaging in misreporting (see *Update 08*). As their leakage rates have fallen, there has been a corresponding rise in complaints from households and plumbers about a low water pressure problem. Perhaps the two are connected. The water companies are obliged to maintain water pressure otherwise they must pay a customer £25, but in the world of information asymmetry, this could be difficult to prove. It could be that, as with car companies, the cost of the fine to the water company times its likelihood is less than the fine from the regulator. The expected monetary loss from the former is less than the latter.

In a sort of oligopolistic, non-price competition world, with fixed price and falling demand, firms are forced to shave the quality of services to expand margins. Free items normally thrown in to takeaway bags are no longer there. During the year, in Huston, Texas, burger restaurants were charging for extra maple syrup or ketchup. Brands of toilet paper became narrower and cheese slices were reduced from 24 to 22 slices.

Supermarket Competition

The number and type of stores tell a story. Tesco has the largest number of any category but one and then it is a close second. In October, the Competition Commission decided to pursue a competition test requirement on a local authority when deciding new supermarkets. However, it only applies to the larger new stores, not extensions.

	Asda	Sainsbury	Morrisons	Tesco
Convenience		268		1634
Mid-size	31	376	343	517
Hypermarket	312	164	44	307
Total	343	808	387	2458
Market Share	17.4%	15.8%	11.3%	30.9%

In 2003, Tesco bought a 44,000sqft Co-Op store. It was instructed by the Competition Commission to sell it. However, if purchased by a rival it would then pose competition to its Slough hypermarket store, less than a mile away. Tesco agreed to sell the store, but it was demolished in 2007 and plans for a replacement store of 29,900sqft were posted and the site was sold in November 2009. Rivals estimate that the lack of local competition whilst there was no competing store was worth £200,000 a week in revenue and the replacement is too small to compete with Tesco's hypermarket.

Rational Profligacy

A price war to some extent is fought in the mind. If consumers believe that prices are lower, they will buy more. Are people that foolish that they are driven by bargains rather than need? Sheila's Wheels, an insurance company, reported results of a survey into purchasing behaviour. As rational man, a consumer only buys something that enhances their utility. The survey found that the lure of a sale price blinded them to reality. Some bought a DVD (33%) or a book (26%) that they had not watched or read. 60% bought clothes they never or hardly wore, with about 10% of a woman's wardrobe falling into that category. Overall, the average annual waste of money per year was £85.60.

Taking advantage of this bargain blindness, supermarkets often claim a price reduction when there is little to suggest this. During Q1 of 2010, the supermarkets exchanged blows. They changed pricing strategies and advertised reductions. Comparing prices on January and March 1st, MySupermarket.co.uk found that 67%

of prices were unchanged. Of the alterations, a marginally smaller number had gone down than up (15% vs. 18%). In other words, prices in Tesco, Sainsbury's, Ocado and Asda were more likely to have risen in the alleged price war. Also, prices of around 4,000 products were rounded to £1. Here things were different: 44% of prices were reduced and 8% were raised to £1.

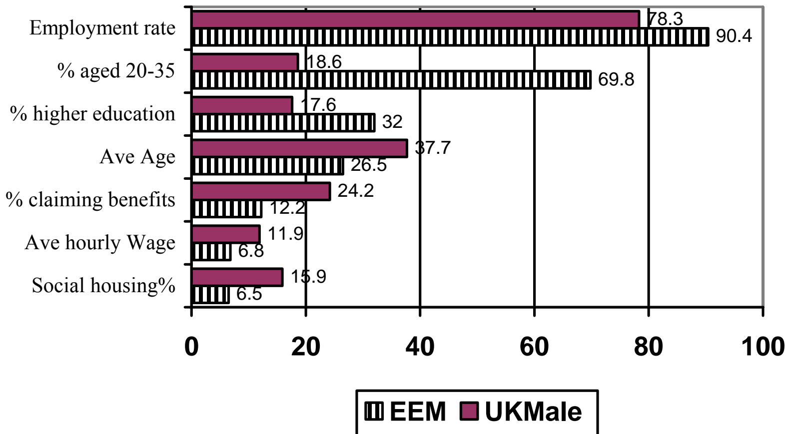
The discussion of the oligopoly kinked demand curve found in micro texts predicts sticky prices and price wars only when desperate or a significant blow is to be struck. This is predicated on absorbing the price cut. Supermarkets are so large that they force their suppliers to bear some of the cost. So a price war could be beneficial to the retailer, not the producer. To combat the imbalance of negotiating power dairy farmers are seeking to join cooperatives. Co-ops cannot issue shares or be taken over. This has obvious benefits, but raising capital is problematic. Collectivising to form a quasi monopoly is a way of addressing the power imbalance inherent in the negotiations and profit-shifting. For example, over the last 10 years the merger of 15 grain co-ops resulted in a large co-operative, Openfields. Now, it has a turnover of £550m and, through its size, can afford to hire 13 specialist traders using complex trade instruments.

Behaviour

Consistent with conventional migration theory, 88% of migrants surveyed were motivated by financial reward. totaljobs.com having surveyed 66,000 migrant employees, found that 22% chose London; 12%, New York; and 12%, Sydney, making the UK capital the most popular destination worldwide. Within the UK, after London came Manchester, Aberdeen and Birmingham. More than half of those destined for the UK were qualified to degree level in such areas as finance and engineering.

It is suggested that there is more about migrants, whether they have more human capital or not. Evidence that the 500,000 immigrants to the UK from the 10 countries that joined the European Union in 2004-8 and were eligible for benefits have contributed more in taxes than they receive in benefits and services from the welfare state was revealed in July 2009 by Professor Christian Dustmann, of University College London, who carried out the study. Compared with a native worker, on average, the EU immigrant was 60% per less likely than to receive state benefits or tax credits, and 58% less likely to live in social housing. They are younger, likely to have fewer children, be better educated and work than their native counterpart. In 2008/09, they made a net budget contribution (direct and indirect

taxes – benefits and from public services such as education, the National Health Service or social housing) of +37%. The corresponding figure for a native was –20%. The diagram below summarised some differences. One can understand why Lady Jo Valentine, of London First, a group representing many FTSE100 companies, might, in the light of Coalition proposals in July 2010, describe a cap on non-EU migrants to the UK as 'economically insane'.



Yet again the recession brings new evidence of a change in behaviour. B&Q noticed in February and March that the sales of vegetable seeds had grown by a factor of three, outselling those of flowers. Indeed, over 10 years, the ratio of vegetable to flower seeds has shifted from 30: 70 to 78: 22.

A Consumer Focus survey of 2,013 reported in October 2009 that UK customers were 'bewildered' by the 1.3m packages available for calls, texts and other phone functions. Many made adverse selections, overspending or paying 'hidden costs'. Moneysupermarket.com found, in May, that 63% of those that swapped credit cards to zero% balance transfers, although they did not intend to, went on to use the card for additional spending. These people are likely to be poor money managers.

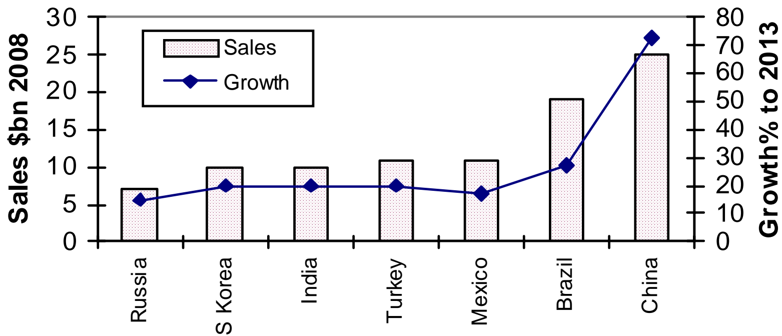
Pupils are being bribed to learn with TVs and iPods in a High School in Macon Georgia. This is part of the Texas Advanced Placement Incentive Scheme. Postmen and Liverpool firemen may win a car. A reduction in absenteeism is one way of saving money and central to the efficiency drives debated at the election.

Pharmaceuticals

Profit margins vary from industry to industry. For example gross margin at Matalan 49.2%. Pharmaceutical companies tend to be more secretive sector, particularly about margins on individual products. Bernstein Research estimated that ten of the most prescribed medicines have a margin of over 80% and the average of the top 40 was over 50%. Effxor XR, Pfizer's antidepressant, had a margin of over 87%. Pfizer also holds a patent on Lipitor, the world's best selling cholesterol-reducing drug (sales of $11bn in 2010), which had a margin of 82%. Falling outside of the patent period can reduce price by 90%.

Countries have been lowering prices and breaking patents. Due to an increasing desperate budgetary position of the health services and the government, Greece reduced, compulsorily, the price of drugs by between 3% and 27% in May. In early September 2009, India decided to overturn a patent, held by a US company, on an antiretroviral drug, Tenofovir. This is not unique; Brazil did this with other HIV drugs in 2007 and the Philippines imposed sharp cost reductions in 2009. A concern for the patent owner, Gilend, is that the Indian company that wants to manufacture this drug, Cipla, refused to agree restrict supply to India. More rigorous patent law was introduced in India in 2005, but in some other low income countries Tenofovir is not patented so generics can be purchased. Rather it sought to challenge the patent so that it could avoid royalties and supply Brazil and China.

In November, GSK announced a cut of patented drug prices for developing countries. This could be a response to India etc. but their head of emerging markets, Abbas Hussain is convinced that, unlike Amgen of the US, some drugs are price elastic. Emerging markets, listed below had a global market share of the pharmaceuticals market of 13%, compared with 41% in North America and 27% in Europe. China's market of $25bn in 2008 is expected to grow over the next 4 years by between 68 and 78%. The marginal cost of producing pharmaceuticals is tiny, so a forced price reduction in exchange for access to a vast and growing market may not be so bad. If Abbas Hussain is right about price elasticity, revenues could rocket. Given the growth in population and income, UBS sees 70% of the market growth to 2020 in pharmaceuticals in India, Russia, China, Mexico, Brazil, Turkey and Korea.



In September, Merck and the Wellcome Trust announced an alliance, based in India, to develop vaccines. This represents a pooling of public and private sector funding in a not-for-profit environment. This may represent a shift towards Merck having a strong commitment to CSR. It could also be viewed as part of a shift towards a restructuring of the sector where speeding up and lowering the cost of clinical trials. This could entail pooling of resources, information and personnel with other pharmaceutical companies. It could also involve the reduction in the number of managerial levels. Sanofi-Aventis, for example, had 11 levels in R&D.

A further example of cooperation also announced in September was a joint clinical study of Tamiflu from Roche and its rival from Glaxo, Relenza. The antiviral drugs might better work in combination than when prescribed on their own. The results, unfortunately may find that one is better than the other and joint prescription may be fruitless.

Cadbury-Kraft

In early September, Kraft, based in the USA, put in a bid for Cadbury. Despite a revised offer, perhaps with one eye on history, the bid was repelled. The chocolate confectioner, based in Bourneville, has a reputation, not only in chocolate manufacture, but also in the social engineering of the founder.

There are parallels between this hostile takeover with the Nestlé-Rowntree affair. In the 19th Century, also founded by Quakers, Rowntree another UK chocolate manufacturer, was based in York. It merged in 1969 to become Rowntree-Mackintosh, going public in 1987. Rowntree made Kit Kat, Smarties, Aero, Fruit

Pastilles and Black Magic and Mackintosh made Rolo, Munchies, Caramac and Quality Street. Rowntree-Mackintosh was subject of a takeover battle between Nestlé and Jacobs Suchard in 1988. The Swiss food conglomerate put in two bids for Rowntree. Nestlé eventually won control. The brands were reduced to either Nestlé-Rowntree or, just Mackintosh's Toffee. Symbolic of the relationship, and potentially that of Kraft-Cadbury, Rowntree, eventually was dropped from the packaging.

Initially, capital spending in York rose from £9m in 1987 to £19m 1989 with £14m on processing and £15m on the Polo mints factory. Then a restructuring shut the Norwich factory in 1992. In 2006, Smarties (Germany), Black Magic (Czech Republic) and Dairy Box (Spain) relocated and the York main site was closed. In 2008, a new Aero factory opened and in 2009, Nestle launched Randoms under the Rowntree brand.

This sorry tale of takeover can be analysed from a NIDL perspective. Once an overseas conglomerate owned the plant, there was a problem of distance, both physical and metaphysical. One prediction of the NIDL is that factories are likely to lose their managerial capability as decision-making is sucked in to the conglomerate HQ. A promise that Rowntree chairman would report directly to the Swiss HQ in Vevey was reneged on within 5 years. It was alleged that the quality of marketing was not as sharp after the takeover. Also, factories are more likely to be shut down. Martin Simons, pointed that 11 net factory closures occurred from 2003. The production units are also way subject to cost pressures. Many of the products are well established (i.e. commodities) and do not required specialist knowledge to produce them. Production in Spain, Bulgaria and the Czech Republic acts as a threat as one plant was played off against another. The cost of sugar was a factor. Higher in the UK than in Europe and the US, production costs were making profits difficult for British chocolate makers. In 2007, the UK workers agreed to a pay freeze.

Closer to the Cadbury case, another chocolate manufacturer, Terry's, owned by Kraft but also based in York closed with the loss of 316 jobs in 2005. Production of Terry's Chocolate Orange and All Gold selection boxes moved to Sweden, Belgium, Poland and Slovakia. Perhaps Kraft could rundown Cadbury like Nestlé did to Rowntree.

In November, Cadbury rejected a £9.8bn offer from food firm Kraft. Several other confectioners began to consider their options. US chocolate maker Hershey was considering launching a solo bid of at least $17bn Cadbury. It also considered a joint bid with Italy's Ferrero. Interestingly, Ferrero is a family owned multinational and Hershey is owned by a charitable trust.

The Miracle of Pressure on Managers

In December, things hotted up. Mandelson challenged Kraft not to engage in asset stripping, pointing out that the government would oppose the takeover if it did – an empty threat. In January, he asked shareholders to be critical. Cadbury issued some revised targets. As one might expect they showed a more favourable view of the future. Consistent with alternative goals of the firm and the difficulties monitoring managers, when pressed into looking at the issues that might appeal to shareholders, more returns were found. So growth targets were increased from 4-6% to 5-7%, an increase in profit margins to 16-18% and an over 9% increase in dividends per share. In the past, profit conversion to dividends was about 50%, the new target was 80-90%.

On 19th January Kraft bought Cadbury. Warren Buffett, the largest shareholder in Kraft, described it as a dumb deal, at least on a tax-efficiency basis. Kraft dismissed senior managers and, in February, announced the shutting of the Somerdale factory, shifting production to Poland, costing 400 jobs. Mandleson appeared incensed despite Kraft's insistence that Cadbury knew of their intention: indeed, Cadbury made the same decision in 2008. At the end of March, due to an obscure clause Kraft found it could not shut the final salary scheme. To reduce the pension liability, Kraft gave 3,600 Cadbury workers an ultimatum: switch to a cheaper scheme or face wage freeze for 3 years.

In May, it was announced that Cadbury's bases in Uxbridge and Bournville were to become Kraft's new UK HQs. The European HQ is in Zurich. R&D was to be switched from Munich to Bournville.

The integration of Cadbury's management team into Kraft began in March. Of the 17 on the old board 12 were absorbed into Kraft's team. However, of the 150 staff at the old HQ, only 30 new positions were available. By May, Kraft was reeling from a loss of these staff. The most senior executive absorbed, Mark Reckitt, would not move home. A further 4 were also leaving. By July, 120 out of 165 senior staff from Bournville and Uxbridge had left.

The cost of the merger to Kraft was $18bn, in part to be met by cost synergies. The target of $675m inevitably meant job losses, despite reassurances. Kraft was rebuked in May by the Takeover panel for giving assurances of preserving the Somerdale plant it later shut. Interestingly, this rebuke did not affect Kraft, as the panel has no power to impose a penalty, but it did affect the advisor from Lazards,

who was due to become the director of the panel. Also, Its Polish and Rumanian businesses had to be sold under EU competition requirements.

Alternative Goals of the Firm

What are outlined below are total, average and marginal revenue and cost plus profit. Profit maximisation occurs at the highest point on the profit curve and sales revenue maximisation occurs where total revenue is maximised or when marginal revenue = 0. We can explore sales vs. profit maximisation with the following mathematical expressions.

Costs	Revenues
$TC = FC + \alpha q + \beta q^2 + \gamma q^3$ $MC = \frac{dTC}{dq} = \alpha + 2\beta q + 3\gamma q^2$ $AC = \frac{TC}{q} = \frac{FC}{q} + \alpha + \beta q + \gamma q^2$	$TR = p \times q = aq + bq^2$ $MR = \frac{dTR}{dq} = a + 2bq$ $AR = \frac{TR}{q} = a + bq$
$\gamma > 0$ $\alpha > 0$ $\beta < 0$	$a > 0$ $b < 0$ in PC $b = 0$

If $\gamma = 0.003$ $\alpha = 18$ $\beta = -0.35$ $FC = £150$ $a = 30$ $b = -0.25$ and if $Profit = TR - TC$

$$\Pi = -FC + (a - \alpha)q + (b - \beta)q^2 - \gamma q^3$$

$M\Pi = \frac{d\Pi}{dq} = a - \alpha + 2(b - \beta)q - 3\gamma q^2$ When = 0 ? $0 = 12 + 0.2q - 0.009q^2$

Solving using $q = \frac{-b \pm \sqrt{b^2 - 4ac}}{2a}$, $q = \frac{-.2 \pm \sqrt{.04 - (4 \times -.009 \times 12)}}{2 \times -.009}$

q = 49.28 or –27

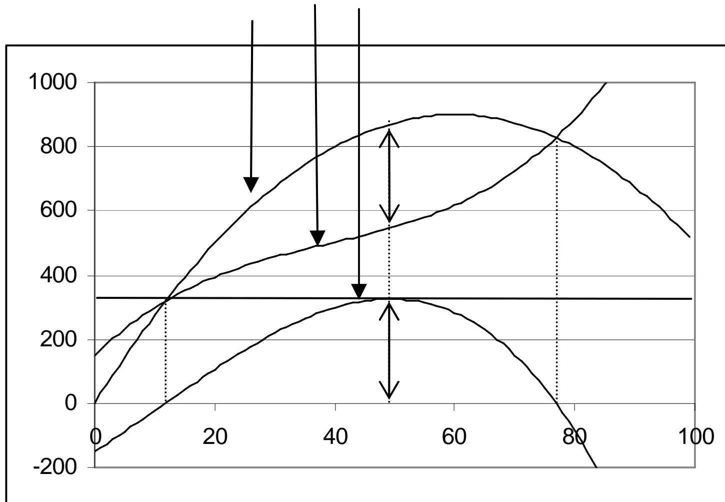
$\Pi_{max} = \frac{d^2\Pi}{dq^2} = 2b - 2\beta - 6\gamma q$ If q = 49.28, –ive therefore there is a maximum of £325

$TR = 30q - .25q^2$ $MR = \frac{dTR}{dq} = 30 - .5q$

$TR_{\max} = \dfrac{d^2TR}{dq^2} = 2b$ -ive therefore there is a maximum

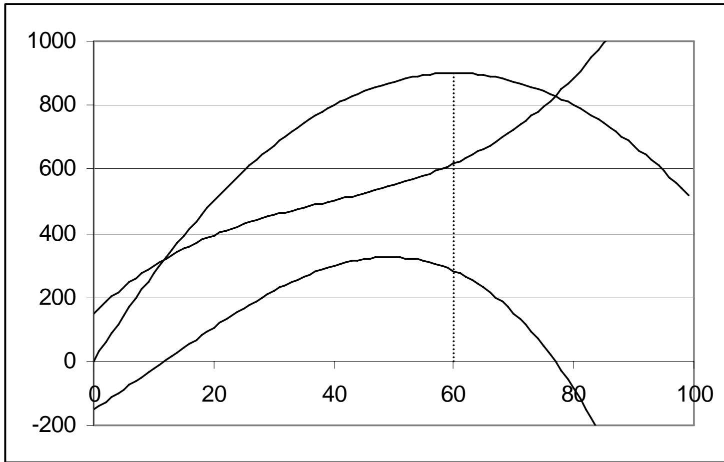
TR is at a maximum when *MR* = 0, *q* = 30 ÷ 0.5 = 60, *TR* = £900 with a profit of £282

Profit maximisation occurs at *q* = 49 < sales revenue maximisation at *q* = 60
In the diagram below *TR* – *TC* = π

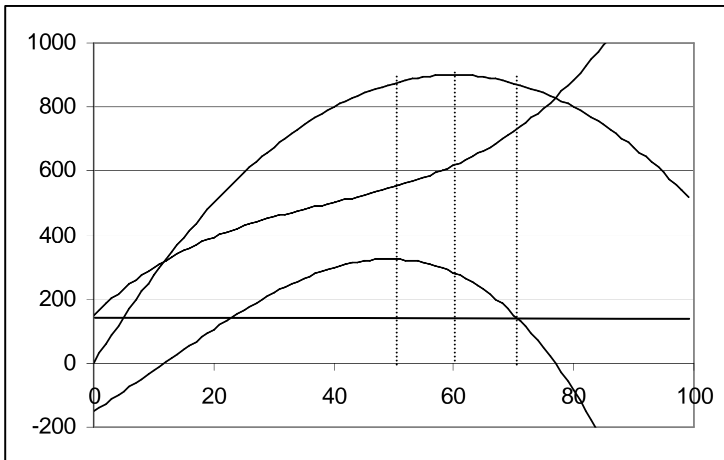


Profit is zero at two points where *TR* = *TC*. Where profit curve is at its greatest (profit maximisation) the gap between *TR and TC* is at its widest. This gives us *q* = 49.28, and a profit of £325.

Shifting to a goal of sales revenue maximisation alters the operating quantity. The maximum sales revenue occurs at the peak of the *TR* curve, the quantity. *TR* is at a maximum when *MR* = 0, *q* = 60, *TR* = £900 and a profit of £282.



Suppose that the manager did not seek to maximise sales revenue, but sales (*q*). The maximum sales that the manager could target and not make a loss is about output 78, with a total revenue of 827. However, shareholders, we will assume, will not accept this. They will impose a profit constraint on the manager. Assuming the profit constraint is 150, the maximum sales volume is 70 units. Clearly, the greater the profit constraint, the closer the output level will be to the profit maximum one.



Flexible Labour

In *Update 09*, the issue of the US's vaunted labour market flexibility was questioned and well as Europe lamented inflexibility. The metamorphosis of the US labour market continued during the year. Traditionally, compared with Europe, the long term rate of unemployment as a proportion of total unemployment, was low. Germany's proportion reached 57%, France's 40% and the UK's 25%. This year, in the US with an unemployment rate of 10%, 36% were long term unemployed.

It was demonstrated that Europe was indeed being [uncharacteristically] flexible with pay holidays, freezes and cuts to preserve jobs, but both the US and Europe were engaged in stimulating their economies (well, after a fashion). In the two years since July 2007, the US unemployment rate had grown 3.8 percentage points. By November 2009, this gap had risen to 5.6 percentage points. The German rate was still below its 2007 rate by 0.8 percentage points, the UK's had grown by 2.5 percentage points, the Eurozone's by 2.2 percentage points and Japan's by 1.4 percentage points.

Equality Where?

The Chamber of Shipping was most concerned about the requirement implied in the proposed equality pay act in March. The implication was that British-flagged shipping would be forced to pay all crew-members the same rates of pay as their British counterparts. The crews can be drawn from places like the Philippines so equal pay would push up costs. It would increase crew costs by 43% on cruise ships, 81% on deep-sea container ships and 130% on tankers and dry-bulk carriers. As the ship (and hence) owners are (quite literally) mobile, they would change to a low-cost base in, say, Singapore. A survey by the Chamber revealed that 25% of British flagged ships would move.

The benefits of a more flexible labour market do not appear to be that great in the UK. In July, PwC reported that investment in human capital between 2002-2006 in the US yielded a return of 19.8%: the corresponding figures for Western Europe were 8.3% and for the UK 4.6%. The scale of the research is sizeable, covering 10,000 companies, across 40 countries, over 25 years higher. In the recession year of 2008, the rate in the US remained the same but fell in Western Europe (2.8%) and UK (1.7%). PwC's analysis suggests that growing regulation is outweighing trends toward flexibility.

It was suggested that Europe needs to find ways of improving returns on investment, such as reducing absenteeism. A case in point concerns the public sector. According

to the CIPD, it has a rate of 9.7 sick days/ year, and local government's rate is 13.5. These are much higher than the 6.4 in the private sector. On average, the NHS had a 11.4% rate or 23 days absence, with front-line staff peaking at around 29 days absence annually. The loss of productivity for local councils is estimated to cost them £2.54m. Reducing sickness could be a better way of dealing with reducing costs that reducing the number of staff and putting the remaining ones under stress.

Incentivising Employees

Production entails a coordination problem: harnessing the self-interest of many in a way that is socially desirable. Greed is harnessed by an incentive structure, laying out rewards and punishment: the monitoring by higher authority, such as a line manager or shareholder, restricts indolence. However, the rewards associated with this problem are unclear. In a principal and agent scenario, if monitoring a junior is equally arduous right the way down a management hierarchy, the salary should be the same for all. A manager receives the same as the person they manage: the reward is for effort. The normal explanation of the greater rewards as one climbs the ladder is responsibility. But what does this mean?

In a sense, it has to do with risk. To some extent, the CEO is taking a risk with their reputation. So that they would command 'competitive' remuneration, senior managers would be keen to maintain a reputation for financial and managerial rectitude. If the company fails to perform well, they are responsible and will be disciplined by the market – which means lose their job and find it difficult to find another, similar position. If the rewards are out of line with the risks and penalties, the CEO has an incentive to act in a manner not necessarily in the best interests of the company.

Shareholders want their companies to take 'appropriate risks' and from them, profits are earned. Shareholders have difficulty in measuring the effectiveness of their agent, so a reward system is put in place to align the interests of the chief executive with those of the shareholders. This can include using profit or growth measures related to remuneration. This can fail because monitoring even these 'measurables' can be difficult. Take financial services. Phillipon and Reshef assessed that between 30-50% of the wage differential between the financial and non-financial sectors in the US is 'rent'. The financial services employee (agent) is able to exploit the weak monitoring of the employer.

In the light of the discussion on incentives, the responsibility for managing the company on behalf of the shareholders and others rests with the CEO. We consider debt, equity and risk incentives.

As discussed in *Update 09*, Miller and Modigliani (MM) suggested that, in a perfect capital market, a dividend policy does not matter. Their work also had implication for long term financing - debt or equity? This would be affected by the risk profile of the assets. Sadly, distinct tax treatment tends to favour debt over equity. Interest payments on debt are tax deductible whereas dividend payments are not. The result deters firms from holding reserves and encouraged debt finance. This, in part, encouraged a wave of leveraged buyouts by private equity investors and share-buybacks. This bias, though, ignores the cost of bankruptcy. With 100% equity no one can force the company into receivership. Debt requires periodic servicing. For the shareholder, bankruptcy presents a huge cost. In hindsight, swapping debt for equity placed an inherently risky business, such as banking, in an unnecessarily dangerous position. David Miles of the BofE is now concerned about the bias and the bank's shift. Interestingly, as they can shift from debt to equity, Cocos are one way forward. John Plender suggested, rather than reducing the tax base by making equity also deductible, removing the tax advantage is an alternative solution. However, Croatian corporate tax income was reduced by a third when they made equity deductible also, which is not what the Chancellor of the Exchequer is likely to be planning.

As mentioned above, a standard model to overcome the principal-agent problem where monitoring is difficult by the shareholders is to align senior executives' interests with their own. This means provide incentives to maximise shareholder value, by linking pay to share prices. Following the profit maximising doctrine, this is the best way to run efficient companies. Hamid Mehran, a senior economist at the New York FED, suggests this is flawed. Instead, this created a problem, particularly with banks. The average non-financial company is composed of a 2:3 debt to equity ratio. But at banks, the ratio could be 19:1. Raising profits and hence equity prices is less likely to lead to a stable business, which is what you require to protect the long term value of debt. Thus, profit incentives promote excessive risk-taking for a bank. A solution is to tie executive pay to the performance of bank debt, measured either by bond prices or CDSs.

Of course with greater debt financing the company has cheaper finance but is more risky *ceteris paribus*. Despite the US's and UK's well developed stock exchanges that should provide long term finance in the form of equity for businesses, the Treasury estimated for 2007 that only around 59% of finance came from equity. This was about the same for German corporates, but notably less than the 71% for

France. For the four countries 14%, 9%, 3% and 5% come from corporate bonds respectively. As with the previous credit squeezes non-banks consider their alternatives. Siemens expressed concerned about the future of many banks in Europe and thought that it should create its own bank. German companies traditionally relied on bank finance, but companies like MAN and HeidelbergCement have shifted towards corporate bonds. MAN's shift is considerable. In 2007, 60% of finance came from banks; in 2010 it was 8%.

Stewardship

Corporate governance again was an issue in 2010. In April, the CEO of Unilever, Paul Polman, joined Jack Welch in questioning the notion of shareholder value as a goal of the firm, suggesting it is potentially harmful. Focusing on the needs of the customer, as Drucker argues, would, in the long run, serve the shareholder. Later in April, a Stewardship Code was presented by Sir David Walker. As a radical departure from the discussion above, he proposed that shareholder engagement would improve, with the company paying the shareholder. Although dividends are one reward from holding equity, Sir David suggested good stewardship, should be beyond that. Holding poorly managed companies to account requires time and money. Corporate failures of the recent past, such as with the banks, are held up as examples of shareholder failings.

At the Zermatt Summit in June several speakers spoke against Friedman's great conviction about CSR. It was felt that promoting shareholder value as a means of maximising social well-being was flawed and that there should be some other way of furthering the common good. Colin Melvin of Hermes Employee Ownership Services suggested that shareholder engagement is the best way forward. The balancing act requires creating sustainable value whilst being accountable. Because of short-termist fund managers and weakly targeted incentive structures, the company remains quick-profit oriented. The asset mangers should have their interests realigned to be in common with the ultimate owners of the shares, the pensioners. Utilising Global Reporting Initiative, which incorporates 90 indicators of performance, including non-financial measures, is yet another approach. Steve Waygood, Chief of Sustainability and Engagement at Aviva, is an advocate. Following the granting of controversial bauxite mining rights to Vedanta by the Indian government, Steve suggested that the publication of balance sheets incorporating human rights, health and safety and environmental impact, companies that pay less attention to ethical concerns could find themselves short of finance: raising capital could be more difficult and the cost of capital higher. Corporate debt accounts for 85-90% of the assets UK insurance companies use to support annuities they provide. The influence of insurance companies, such as Aviva, is significant.

Of the £300bn corporate debt market, insurance companies account for £140bn. If members of the ABI are moving in this direction, stewardship is likely to move away from short-termism without the impetus of official codes.

An alternative from Akerlof and Kranton suggests a change in approach to management of a risky business, identity-economics. As in financial trading where the normal checks are ineffective, the normal utility (compensation) maximising model produces poor outcomes. They put forward a number of propositions:

1. they suggest that, in a principal-agent approach, the agent knows more than the principal, so if it had to establish in a risk-oriented business whether the results of the decisions made by the agent today were good, it probably could not. Commonly, the outcome emerges much later. As with quasi markets and measures, the traders have an incentive to represent the truth in the best possible light, manipulating what others do not understand. Also, as discussed in *Financial Update*, the agent may be too sophisticated for the principal.
2. they also aver that incentives and bonuses attract those that are interested in incentives and bonuses i.e. risk lovers.
3. extrinsic can crowd-out intrinsic rewards. Being paid for something may change how it is valued, for the worse. In a sort of moral framework, virtue ethics, doing good is not only a goal but also a reward. By aiming to do good, the coordination problem is addressed; everyone wants to do good. The financial incentive is anathema in this system; it shows bad faith.

As with Ouchi's (1980) clan, a significant programme of socialisation is needed to shift from money to virtue-based goals. It is also Smithian in that they argue the approval of a group which whom one identifies is the norm. It is problematic for Smith though who posited that the partial spectator guided the agent to behave in a socially divisive manner. For Akerlof and Kranton the norms of the identified group can induce desirable behaviour, so the partial spectator could produce good outcomes, but this requires significant programme of socialisation to gain the 'right' identification. It is also refreshing that Akerlof and Kranton seek to bring ethics back into economics.

The motivation point is supported by a survey of workers. YouGov and the National Training Awards find that the biggest motivator for 43% of those surveys is a passion for the job, not the wage. Less than a third were motivated by the money. An employer's commitment to training made 69% of respondents feel it motivated them to work harder and about the same figure for making them feel valued.

What is needed is for individuals to identify with the company so that its norms coincide with those of their employees. The individual should not be motivated to mislead or game, but represent their employer. The rewards should not be financial.

Targets are not consistent with this approach but there are cases where incentives are tied to broad social goals, which can be viewed as a move in the right direction. The Dutch life sciences group, DSM, proposed in February, linking management bonuses to targets related to greenhouse gases, environmentally-friendly products and processes and workforce morale.

Bonuses and Shareholder Activism

With managerial theories of the firm and models concerning alternative goals the senior managers are poorly monitored and engage in activities that suit them whilst placating shareholders. Given the above discussion, a manager being replaced by disgruntled shareholders or a company's remuneration report being rejected affects the reputation of that manager. It appears that shareholder activism is lowering the degree of CEO's autonomy. Some cases are below.

It was felt that the RBS takeover of ABN Amro, which was voted through by 94%, taught shareholders a lesson and, as such, shareholder activism is growing. Five company reports were voted down in 2009 by shareholders. The leading group in the policing of corporate governance is the Association of British Insurers (ABI). ABI and the National Association of Pension Funds each own around 12% of UK company shares by value. Individuals own 10%. The institutional holding is down from 24% and 18% in 2000, 32% and 20% in 1990 and a joint 80% in the mid-1980s. Overseas investors own 40% of UK shares. EuropeanIssuers, a group that represents 9,200 stock exchange listed companies in Europe, suggested, in September, that there had been a share-drop in the holdings of long-term investors, which is a concern. Falling from 45% before the crisis in 2007 to 25%, this leaves their investor-base more volatile and a lack of knowledge of with whom to engage in debate when things are difficult.

HSBC's CEO, Michael Geoghegan, consulted shareholders about a 36% increase in his basic salary to £1.4m for 2010. With his bonus from 2009 of possibly £4.3m, one is not surprised that shareholders, in February, thought this ill considered. In May, this occurred again, with Standard Life actively voting against the package. In September 2009, the head of Shell's remuneration committee chair, Sir Peter Job, and Lord Kerr, appeared to be sacrificed following an embarrassing 59% vote against the remuneration report at the AGM in May 2009. What raised ire was that, despite targets being missed, bonuses were still awarded. However, several other companies in the oil and gas sector also awarded such unearned bonuses. Equilar, the executive pay analyst, found that average compensation rose in 2008 despite mostly negative returns for investors.

DSG International, the electricals retailer group, put in place, in September 2009, a scheme for executives. They could opt to sacrifice up to 25% of their salary for share options, but this is not based on performance. Standard Life supported the plan, whilst the ABI was uncertain whether it breached guidelines on best practice.

Rather than rely solely on the remuneration committee. Bellway, the builders, in October, decided to consult shareholders. This follows the 2008 financial year committee decision being voted down by shareholders.

Cable and Wireless found its proposed 17% pay increase ($1.1m) to its CEO, Tony Rice, was voted down in July. ABI suggested the reward structure was based on variables largely beyond the control of the CEO.

Following a rule change by the Tokyo Stock Exchange, companies were obliged to publish the remuneration of executives earning more than ¥100m. This revealed that foreigners were among the best paid, with Ghosn of Renault-Nissan as the best @ ¥890m. In June, four foreign executives resigned from the loss-making Shinsei as a result of the rule change. Strangely, even within Japanese companies foreigners did well. Eisai, a drugs company, paid its US senior VC, Lonnel Coats, ¥140m, but its CEO, Haruo Naito, ¥136m.

The Prudential's bid for AIA, the Asian arm of AIG, was made on 1st March. It lasted 2 months and was scuppered by a shareholder advisor. RiskMetrics, which advises 2,400 clients worldwide on voting behaviour, recommended voting against the takeover, at the price offered ($35.5bn) by shareholders. Within a week, on 1st June, following rejected lower offer of $30.375bn, the deal was essentially dead, leaving the Pru with a bill of £450m in fees and currency hedging. Having made it an issue of confidence in him, this put the CEO, Tidjane Thaim, in an almost untenable position. He stated later that he would not resign over this, but shareholders brought pressure to bear against him and the remuneration committee's recommendation made about the same time. The costs of the failed takeover were not inconsiderable. It was estimated that £153m went to AIG for time wasting: £150m in currency hedges; £66m on Advisory fees; and £81 on underwriting fees. This £450m raised considerable ire, as dividends in 2009 were £344m. In August, the interim divided was 5% higher (6.61p vs. 6.29p) so that Tidjane Thaim could make peace (placate) with shareholders.

As a measure of a manager/ management, any rumour can alter share price. In July, reports emerged about the board of Nokia trying to oust CEO, Olli-Pekka Kallasvuo led to an immediate 5% jump in price. A few days later a major Vodafone investor, the Ontario's Teachers Pension Plan, was seeking to replace the chair, Sir John

Bond, with the CEO, Vittorio Colsao. Ontario's Teachers were dissatisfied with recent acquisitions by the company. From a managerial goals of the firm perspective, growth through acquisition may have cost the chair their job. It did not, though, in the end.

In early September 09, the Dutch bankers' association and the Dutch finance ministry revealed a code of conduct that will limit bank executives' bonuses. The CEOs of France's largest banks, including BNP Paribas, Société Générale and Crédit Agricole agreed with President Sarkozy that guaranteed bonuses will be limited to one year, with at least ½ of these payments will be deferred to a later date, of which ⅓ should be paid in bank shares. In the US, Kenneth Feinberg, a 'pay tsar' can veto bonuses or take back money on contracts made before 11 February from those at companies in receipt of TARP funds. Bankers in Germany could be asked to repay bonuses if the risks they take are later deemed too high.

In July, the EU announced rules on bankers' bonuses that seemed open to interpretation. The rules are:

- Bonuses must be proportional to salary;
- Banks should defer between 40-60% of bonuses to employees that materially affect the banks risk profile;
- At least ½ of all upfront payments must being shares or other instruments linked to banks' results and upfront cash limited to 20-30% of the bonus;
- Deferred bonus to be clawed back if performance slips in subsequent years.

These rules amount to the 'toughest in the world'. The language ties the bonus to performance, not to share price explicitly, so there is scope for some flexibly in the arrangement. However, the rules may be undermined by regulatory arbitrage; staff move to where they can earn higher bonuses for what they do. A week after the EU pronouncement on bonuses, the UK Coalition government announced that it will leave bankers to self-regulate bonuses.

Bleeding Staff

RBS Coutts, an investment arm of RBS based in Singapore, in October lost 20 managers and 50 support staff as a mass resignation of ⅓ of the office's staff over loss of their possible annual bonus. The 3rd largest hedge fund in Europe, BlueCrest Capital, based on fears about recruiting talented staff, announced, in November, that it was to move to Geneva. This occurred at the same time as the Swiss regulator, Finma, rejecting bonus limits. Lehman Bros., in December, was having to pay $50m bonuses to prevent London 230 derivative traders from leaving. These are needed to help the administrators PwC unwind deals. Credit Suisse accepted a proposed rewards scheme in the face of shareholder criticism (29% objected). UBS's

chairman, Kaspar Villiger, defended the reward scheme that 40% of shareholders opposed. He pointed out that, following a poorly received package the previous year, UBS saw the many key staff leave. The biggest departure was an entire team of 60 from the equities unit. Allegedly, this cost UBS SFr800m in revenues.

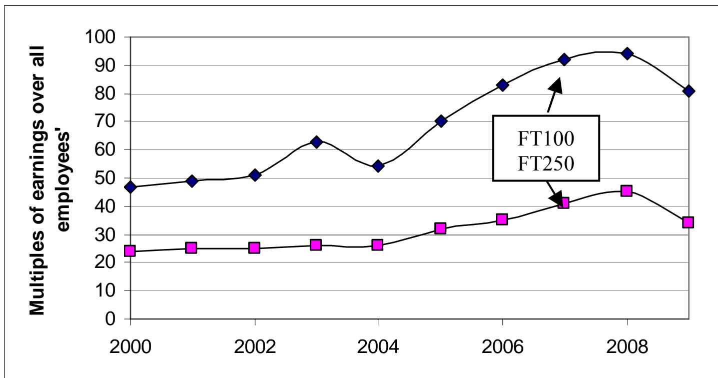
Although too late for Cadbury, the Labour party put in their manifesto something dubbed Cadbury's Law. The proposal was to require ⅔ of shareholders should be in favour of the takeover. Interestingly, fund managers from Schroders claimed it would be damaging for pension funds, shareholders and inward investors.

Leaders' Pay Restraint

In the first quarter of 2010, the American 'investment' bank, Goldman Sachs, reported net earnings of $3.46bn. The bonus and pay pot of $5.5bn meant the average employee received $166,000. The level of profit and remuneration both seem excessive, but why? On a very basic level, as with footballers, if someone pays that reward to someone, they must be worth it. They have skills and talents that, when marshalled, result is spectacular profits.

If we apply this to chief executive officers the same goes, they must be worth it. As a time when many lower paid workers were accepting pay freezes or cuts, the CEO of Kraft, Irene Rosenfeld, was awarded a 41% pay increase to $26.3m based on her performance, in part, related to the takeover of Cadbury. This sort of reward, though, does breed resentment. The gap between the average and those and the top seems too great. According to IDS the UK's 100 largest companies' CEOs earned an average of 49× the average wage of full-time employees in 2000. By 2009, this had risen to 81×. In the US the Institute for Policy Studies estimate the equivalent figure in the US is 319×. The average pay for CEOs of UK's 50 largest companies in 2009 was £3.7m. In the chart below the upper line shows the CEO multiple over the average pay of the top 100 and the lower one of the CEOs of the FT250. The differential was, in 2009 only 34× for the latter group. Larger company CEOs pay themselves more.

There might be a me-to aspect to pay. The management structure of FTSE100 companies is interestingly interlocked. Resources Global Professionals found that of the 1,095 directors listed in 2007/8 annual reports, 101 held positions on at least 2 boards, 9 held 3, and one held four. Beyond this, they often held positions in smaller companies. In the US, 4,936 of the 8,945 S&P 500 directors held more than one board seat.



Inflated View

Perhaps the CEO is worth the money because of the leadership skills that they can offer. Well, they may be deluded. The Chartered Management Institute surveyed 2,000 managers finding that almost half thought themselves excellent at managing their employees. A separate survey of the employees found only 14% were excellent.

Reward but No Effort or Risk

So, one would expect that disgraced CEOs would find is difficult to find work. Andy Hornby, CEO of HBOS at the time of its enforced merger with Lloyds was, in July 2009, appointed to Alliance Boots' board. Former BP CEO, Lord Browne, joined Apax partners and then Riverstone Holdings. Applegarth, Northern Rock CEO when it collapsed in 2007, in October 2009, became a senior advisor of Apollo Global Management. Cerberus Capital Management put Bob Nardelli, the former CEO of Home Depot, in charge of Chrysler before it went into receivership.

This, to some extent, will be a function of the old-chums network. Indeed, this works for politicians. The Advisory Committee on Business Appointments which scrutinise senior civil servants and ministers for two years after they leave office reported in March that almost half of the 46 Labour ministers since the 2005 election were trading on their links with their old department. Attempting to earn fees from their political links, Stephen Byers, Geoff Hoon and Patricia Hewitt were exposed by Channel 4. Lord Bach, formerly a defence minister, took a director's post at Finmeccanica, an Italian arms manufacturer, and Group 4 used Lord Reid, former home secretary as a consultant.

In spite of their spectacular rewards some do not feel obliged to shoulder the implied risk or responsibility. Despite earning $15m a year for running Citi group, Chuck Prince and Robert Rubin did not know or understand and, hence, not take moral responsibility for, the activities of Citi on their watch. In front of a US Finance Crisis Inquiry Commission, they apologised but did not concede that they should have prevented the crisis in Citi that led to its partial nationalisation. They defended their right not to know or be concerned with the rapid growth in exposure of Citi to complex financial products.

Even in the not-for-profit sector the CEO is doing better than the average. As mentioned elsewhere, IDS found that NHS CEOs in 2009 earned on average £148,000 with Foundation Trust CEOs receiving £10,000 more than that. Remuneration for such officer has risen by 13.7% for the last two years; and 100% in real terms since 1999. By contrast, the average nurse's pay rose by 60% over the period.

Some building society CEOs did well, as well. Nationwide's CEO earned £1.54m over 2009, three times the next highest. Interestingly, small society CEOs, such as of the Kent and the Principality received £535,000 and £489,000 respectively, up by 11% and 20% over the year before. The Stroud and Swindon former CEO walked away with £482,550 in 2009 in salary and severance. Other mutuals are not dissimilar, such as Royal London, paid its CEO £1.25m, up by 20.5%. The largest friendly society, Liverpool Victoria, remunerated its CEO, Mike Rogers, £997,000, including a £405,000 salary, despite a £91.4m loss, but at least the package was down 0.5%.

Housing Association CEOs also coined it in. In 2008/9, the CEO of Anchor Trust, John Blencher, was paid £391,000. Executives on the board at L&Qs earned £321,000 and the CEO of Affinity Sutton received £260,000.

With the nationalised banks, pay does not seem to be tempered by embarrassment. Chairman of Royal Bank of Scotland, Philip Hampton, admitted the incentive structure was too generous to its executives. It paid out more that £1m to over 100 employees. Lloyds' chairman, Sir Win Bischoff, defended the potential £6.2m for the CEO, Eric Daniels. Both Goldman Sachs and Lloyds took government money but still behaved in a manner consistent an institution extracting rent. Daniels sought to hide profits from the UK taxman and push up his bonus while Goldman was involved in window-dressing their accounts.

A head-hunting group, Korn/Ferry International, reported in June that the labour market is not homogeneous. There was a shortage of labour at the senior staff level. CEOs and chief financiers were in great demand affecting their remuneration. Perhaps their pay increases are driven by excess demand.

Foxconn: A New Face for an Old Problem

Just as Apple become the largest high-tec company by market capitalisation, one of the manufacturers of the iPhone and iPad, Foxconn experienced yet another employee-suicide. With 1m employees, Foxconn is the largest electronic contract producer in the world, with revenues in 2010 of $62bn, greater than Apple. With 10 suicides in one year, at least two unsuccessful attempts and other cases at other Foxconn factories, there was clearly something wrong. Like a scene out of a Hard Times, the Foxconn factory in Shenzhen is an austere industrial environment. With 300-400,000 workers, it served to provide electronics products for Apple, Dell, Nokia, Hewlett-Packard and Sony. A more general fear is that the Foxconn factory problems are not uncommon. In a poor country, employment practices may not be all that is desirable. Selecting workers on criteria as looks or height or where they come from are characteristic of 19th Century England not 21st Century China. But as with industrialising-England, China is urbanising, absorbing peasantary at a rate of knots. Foxconn, allegedly fearing copy-cat suicides, asked workers to sign an agreement to restrict the legal compensation the might receive from injuries not caused by the employer.

Before the industrial unrest, each day around 8,000 people applied to work at the factory at Shenzhen, which paid the entry-level workers about Rmb900/ month ($132) which is minimum wage, but they earn 50-100% more through almost constant overtime of around 120hrs, associated with the current rush to fulfil the demand for iPads. This pushes the weekly hours to 70. Like an archetypal Fordist factory, managers enforced military-style discipline on the workforce. Activists claimed that shifts at the plant were long (12hrs) and the assembly line moved too fast. The tasks and, hence, hand movements are highly repetitive. This excessive workload takes its toll. Some cannot stop their hands from twitching at night. As a result, some 50,000/ month leave due to burn-out. Apple, Dell and Hewlett-Packard announced that they would review working arrangements. To placate all concerned, the next day, it was announced that wages would rise by 20%. A week after the offer was increased by first a further 10% and then, almost immediately another enhancement that took the improvement to 70% and the average overtime reduced to 80hrs.

Built by Foxconn in Shenzhen, it is estimated that the Apple's iPhone4's labour cost were possibly between 3 and 7% of revenue. A report compiled by iSuppli, a Californian consultancy, estimated that Apple paid:
$27 flash memory (Samsung)
$10.75 applications processor (Samsung)
$14.05 chips (Infineon)
$2.60 gyroscope (STMicroelectronics)

The total bill for materials is $187.51. The average price in the US since Q3 2008 is $600, suggesting a profit margin of as much as 60%. The appeal of building products in China is clear and the possibility of absorbing the higher costs should not have created problems. Given its dependence on Apple, Foxconn took notice of Apple's concerns. Apple uses a limited number of suppliers and possibly 100,000 of Foxconn's workforce assembled Apple products.

Development

As the economy develops, wages rise. In China, where provinces are at different stages of development, industry moves, as it would, from the developed to the developing countries in a NIDL type process. In May, worried by the number of unfilled vacancies and industry relocating to available labour, Guangdong province raised the minimum wage by 20%. According to the People's Daily (paper) there were 2m unfilled vacancies in the Pearl River Delta. Another major export centre, Jiangsu raised minimum wage by 13% in February to Rmb960. The wages in Guangzhou, Guangdong's capital rose to Rmb1030 but, as mentioned elsewhere, property prices would more than outstrip this. Outside, in smaller towns, the wage levels could be Rmb660-810. Factory owners were complaining that this wage rise would make them uncompetitive compared with Cambodia.

Industrial Unrest

At the same time in May, Honda, which paid its workers Rmb1,500/ month and trainees Rmb900, was subject to industrial action at a transmission factory, forcing it to suspend its Chinese operation. Within 2 days, the action of 2,000 workers halted work in all of its four plants including those at Guangzhou and Wuhan. As this represented a significant break with, the official union's position (ACFTU), the industrial action at Foshan marked a significant step in industrial relations in China. Strikes had been banned since 1982. The government forbade the reporting of the strike, but even in a country of restricted information, hoping that the news would not leak out was optimistic. The internet/Twitter is too fast and news of the

industrial unrest spread quickly. Higher pay and selecting their own union representative are significant goals. The workers were asking for as much as Rmb2,500, but Honda offered Rmb1,900. The strikers accepted a 24% increase. This was quickly followed by industrial action at two other plants. Interestingly, the People's Daily criticised the official union, the ACFTU, for not resolving the labour disputes. Honda on the 14th played the take-it-or-leave-it card when is began to recruit more workers at its Lock plant in another factory town, Zhougshan, threatening to replace the strikers.

Honda's Guangzhou plant in China is an export only factory. Consistent with NIDL, it was attracted there in 2003 by cheap labour. Since 2004, minimum wage in the city has risen from Rmb610 to 1,100. Production in 2009 was at around half capacity. Paradoxically, the car industry is capital intensive so the labour costs should not be that important. According to JPMorgan, in Japan, Honda spends 5-6% of revenues on workers' pay. If using the same equipment and wages being 20% to ⅓ of Japanese factory workers, this might suggest labour costs amount to 2% of sales revenue. This may be an important margin. Alternatively, Honda may, like Suzuki (GM), move to India, where wages are half those in China or expand other operations in SE Asia.

In the time of crisis when manufacturing looks to cut cost and move abroad, Samsung Digital Imaging, the Korean chaebol found that, because of currency movements, China was becoming a less attractive place to produce relative to Korea itself. It had moved mobile phone production to Vietnam where it produces televisions. In the first half of 2009, it saw a significant change in the cost advantage of China. AlixPartners suggested, in May 2009, that US production is only 6% more expensive than manufacturing in China + shipping in some sectors, and Mexico is cheaper.

Interestingly, industrial disputes in China, normally few in number and commonly about dire working conditions, had increased rapidly in 2010 but not reported. The multinational plants have been the focus of attention, but there was a qualitative shift from conditions to pay for both national and international companies. This reflects a growing tightening of the labour market in the Pearl Delta. For Honda, this might also be viewed as a realisation that efficiency wages make sense.

Another interpretation of the industrial dispute emerged in late July when Omron, a Japanese electronic components manufacturer operating in Guangzhou, found half of the 700-800 workforce went on strike for higher wages. The dispute about a 40% increase over Rmb1,270 seemed consistent with others in the area. However, there was interesting subplot. One of the concerns was that the Japanese would not

promote Chinese to management positions. Japanese manufacturers did appear to be more heavily hit than others.

Beyond that perhaps, there is a realisation that disquiet may follow if legitimate demands are not met. Accommodation costs are rocketing making the real, disposable wage much smaller in the big cities. To compensate, the City of Beijing raised its minimum wage at the same time by 20%. But other cities were also under pressure. Brother, the sewing machine manufacturer, found 900 workers in their plant in Xian demanding better pay and conditions.

A month later it was announced that Foxconn was shifting production to a lower cost production site in Henan Province, in central China, where minimum wages are lower. It was reported in the China Daily that 100,000 students were drafted in for three months to 'train them up'. The Provincial government was enthusiastically supporting the inward investment. Foxconn discussed the move inland with Apple. Predictably, as with traditional NIDL analysis, footloose factories will move. Minimum wages inland, such as in Wuhu, were Rmb420 and in Wujiang, Rmb700. Delta Electronics, the largest manufacturer of switching power for PCs, operates in both.

In a sort of portfolio approach to production, H.P., Foxconn, Compal and Quanta-Computer have production facilities in Chongqing where, in 2010, minimum wage was 61% of that in Shanghai and 63% of that in Shenzhen. A central Chinese location, though, does count against it. Despite the capital intensity, these labour cost differentials could be crucial to some. The price for a PC fell from an average price of $900 in 2007 to $650 today. This inexorable decline imposes wafer thin operating margins on Acer (3% margin), Dell (4%) and H.P. (9%). Gartner estimate that price will fall again in 2010 by 5 to 10%. In a sense, the NIDL is revisited upon us but within China and South East Asia. Costs, local politics, tax breaks and industrial unrest are themes discussed in the West 40 years ago.

China Under Threat

China as a centre of low cost production and logistics is under threat. As China develops, the more unseemly sides of capitalism related to the exploitation of labour become less acceptable, putting up costs. Also, overcrowding at ports, such as Shenzhen, has pushed companies to look elsewhere. Some, such as UPS, the parcel delivery company looked at Vietnam. J-I-T supply but production based in China for such products as hard disks does not make sense (flying low margin products is not profitable). Predictable demand could be shipped. UPS no longer flies laptops with their manuals to market. Alternatively, there is a trend towards near-shoring or near

sourcing, which involves low cost centres near to high-income centres. Mexico and Central Europe would be examples. With oil at $150/ barrel, this would wipe out most of the Chinese cost advantage. Intellectual property rights are also a concern, keeping some hi-tec manufacturers out of China.

A survey of Japanese multinationals by the Japanese Bank for International Co-operation found that Vietnam was preferable to Brazil, Thailand, Russia, India and China for a source of cheap labour. Recent adverse movements in the exchange rate, industrial disputes and rising costs are shifting Japanese DFI to a lower cost and more compliant workforce.

It is anticipated that with an aging population and the strong Yen, there will be little return in building small cars in Japan. As a result production will shift, probably to south east Asian countries such as Thailand (e.g. Mitsubishi and Honda) or China so by volume, Japan may become a net importer of cars. This is evident from Toyota. Exporting half of its Japanese production, Toyota's plan, announced at the end of July, is to reduce its production of vehicles in Japan by 15% over the next 5-6 years to accommodate the high Yen. Capacity would fall by 30% from 3.9m but no factory would close??? This would be compensated by expanding production in Mississippi, China and Brazil. Adverse currency movements reduced profits by $3.6bn in the year to March.

Multinational Bashing

The economics of building electronic goods is not so good for all companies. Those with thinner margins are keen to shave costs. A H.P. computer involves 3,000 procedures so reducing the number by 10% can be fruitful. The doubling of wages at Shenzhen plus the programmed rise in the Yuan will alter decisions concerning the bottom line. However, there is a broader problem. Outsourcing and producing in China may result in low cost but in 2010 industrial unrest and other problems led to GE to question the economics of it. Having being an advocate of outsourcing to China, Jeff Immelt changed his mind. The recent industrial unrest seems to coincide with a new real politic. Contracts from the state are favouring home producers, with local content rules being applied. Executives from Siemens and BASF concurred. Although Dell announced plans to boost outsourcing from 43% to 80%, Toyota and Honda were apprehensive. The CEO of Manpower, Jeff Joerres, suggested that those companies wanting a 20-25% return from a $1bn capital-intensive investment may go elsewhere. There appeared to be official Chinese acceptance of the car workers striker with the chairman of Guangzhou Automobile supporting a Honda dispute. China wants to move away from low value-added processes and reliance on overseas investors. Individuals have higher expectations. The one child policy, the

rising cost of accommodation, and a growing middle class is conspiring against the Chinese government to allow a more flexible approach to protest. Perhaps the criticism from western firms also reflects this new climate of tolerance.

Consumption

Food is like smoking, but a more contentious issue. It is linked to throat cancer and death rates are expected to triple from the 7,000/ year over the next two decades. Indeed, obesity and poor diet costs the NHS an estimated £7bn. It was reported in *Update 07* that the Food Standards Agency wants a Traffic Light System to be widely adopted by food manufacturers and retailers. However, recommendations/ pressure from the food industry resulted in *optional* compliance in the guidelines published in March. Calling it too simplistic, Kellogg refused to comply. In 2007, Kellogg's Special K had 17g of sugar per 100g, up from 9.6g 29 years earlier.

In April, the CEO of the Food Standards Agency appeared to get his own back. Tim Smith 'declared war on dietary nasties': he set targets on the reduction of saturated fats. Setting a target of at least 10% in chocolate bars, biscuits and cakes is a way forward: another, to reduce sugar intake, is to demand manufacturers make portions smaller with, say, soft drinks and cream eggs.

The food industry won in Europe. The Traffic-Light system was rejected by the EU. The Confederation of the Food and Drink Industries of Europe lobbied successfully in June, to prevent the too simplistic system, favouring *guideline daily amounts*. Evidence from the Australia is that the simpler system does work, particularly among the lower socio-economic groups.

In December, a British Heart Foundation survey of 1,454 parents aged between 16-64 years old with children aged 15 or under found that 90% misunderstood the nutrition information on children's foods. For example claiming the product is: "a source of calcium, iron and six vitamins" is interpreted as the food is likely to be healthy. Believing that 'wholegrain' signifies healthy, 76% of mothers thought that Nestle's Honey Shreddies is a healthy food. This is despite the average serving of 13.6g of sugar.

Perhaps leading the way, PepsiCo pledged to cut the amount of saturated fats, sugar and salt in its branded products. Salt would be cut by 25% on the 2006 levels by 2015 and the other two by the same proportion by 2020. This could be related to changes in the US. The average consumption of salt is 50% more than the

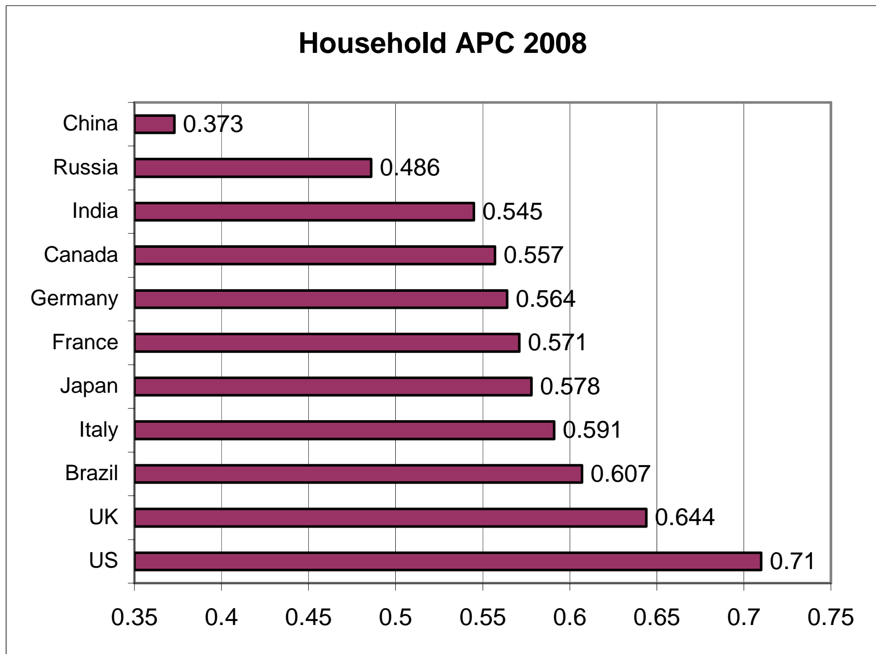
recommended level and it is likely that the Food and Drug Administration's regulation will change.

As reported in previous *Updates*, supermarkets trade on imperfect information and reputation. LG Regulations found that because there is no definition of lean in the term 'lean mince', the amount of fat could vary widely. Testing over 500 packs of mince, it found an average of 27% *more* fat than advertised by the big supermarkets whilst Iceland's mince had 10% less. Supermarkets' minced beef had 67% more fat that the corresponding serving from a butchers. Of course Asda found wiggle room. The tests were imperfect and it was really the supplier's fault.

mySupermarket.co.uk reported that sales of pre/ partially cooked food were increasing. Pre-sliced fruit, ready meals, ready grated cheese, ready-chopped vegetables and pre-boiled egg are classified as 'lazy food'. Rather then preparing it at home, buying such food puts it in the marketised economy and would boost GDP. Sales of such food rose by 14% over two years, with an average annual spend of £63/year/head. These foods tend to have excessive sugar and salt.

Consumption Function

One of the bases of the great imbalances in the financial system concerns the difference between the savings rates in China and in the US. US citizens save too little and Chinese residents save too much. Alternatively, one could argue that US citizens spend too much and Chinese residents spend too little. The US buys Chinese goods and pays for them in Dollars. When the Chinese purchases US debt, these Dollars are repatriated. The spending rates would have to change to correct this process. Below are estimates of average propensities to consume in various countries. The high consumers, the US and the UK have balance of payment current account deficits to address. The US citizen spends twice as much out of their income compared with a Chinese resident.



Despite rising youth unemployment, with rates of 35% for 16-17 and 18% for 18-24year olds, reported in June, TNS found that 74% of the 16 to 24-year-olds it surveyed had the same or more disposable income than in 2009, 63% spent more on clothes. Their spending patterns are outlined below.

Clothing and apparel	23%	Electronics and technology	8%
Cell/mobile phone	11%	Transport	8%
Entertainment	10%	Eating out	7%

It was suggested by Paul Edwards of TNS that their spending patterns might have become engrained in their behaviour. In Friedman's consumption theory, consumption is related to permanent income $C = kY^P$, which is unrelated to current circumstances, where k represents a permanent proportion of income that is spent (≈ 0.9). Alternatively, the adaptive expectations hypothesis proffers the expression $C = kY_{-1}^P + \alpha k\left(Y - Y_{-1}^P\right)$, where α is an element of the unexpected income variation affects today's consumption.

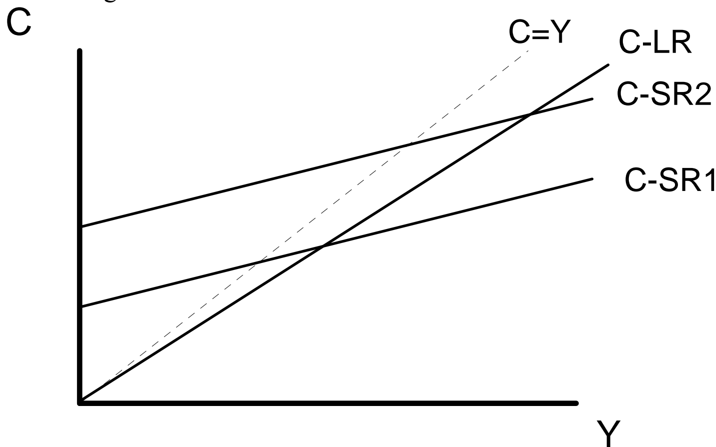
Below is a diagram depicting the distinction between short run (Keynesian) and long run consumption functions. Short run functions, assessed across a large number of

people at the same time, relate their consumption to their current income. The slope of a short run function such as C-SR1 is the MPC, which is could be around 0.6. It could shift with a change in interest rates, encouraging people to save more.

In the long run, over a lifetime, people's consumption is more likely to be related to their wealth, so short term variations in income are less important. The long run MPC is around 0.9, so C-LR is much steeper and does not cross the $C = Y$ line.

Another possibility is an old model, due to Duesenberry (1947). The notion of relative income perhaps is consistent with Identity Economics and conspicuous consumption. Duesenberry proposed that others influence individuals' consumption patterns, so even if someone's income drops, they will attempt to maintain their consumption pattern so that it corresponded with that of the group they identified with, such as their neighbours or friends. This is more likely with teenagers than an idea of the long term wealth and permanent income

Indeed, Spanish unemployment count passed 4m in January and activity fell for the 26th consecutive month. Despite a 19.5% unemployment rate, ⅔ of Spaniards had never had it so good. The €8bn stimulus package kept spirits up; interest rates held holding mortgage costs down; and wages were stable but increasing in real terms as prices were falling.



Restructuring Businesses

Two of it suppliers, Wild Rocket Foods and 2 Sisters Foods were absorbed into Tesco's Fresh and Easy, its US subsidiary. They are Tesco's largest fresh produce

and meat suppliers in the UK respectively. The takeover, announced in June, resulted from disappointing performances.

Demerging was back in vogue. Demerging is the opposite of merger. This could include the divestment of bank or estate agencies as with RBS and Lloyds. At least 12 demergers were listed in February and March with Carphone Warehouse and Cable and Wireless bifurcating in March. Since 2000, 75 European company demergers resulted in the spin-offs out-performing the European top 300 by 16%/year, according to Daniel Stillit. LSE/ Deloitte find that demergers are largely beneficial to shareholders. This may be because 40% of the off-shoots are taken over about two years later.

Inflation

The Affluent Luxury Living index, which is tailored to the very rich, so will include high profile brands, rose by 0.4% in April. Items include Beluga caviar and opera tickets. Items bringing the index lower were Westminster School fees whereas the price of fine art had risen.

With a fear of a double dip recession, investors turned to the prospect of deflation. By June, the expected annual rate of inflation as assessed by the difference between bond and index-linked bonds, was 2.19% over the next 18 years in the US and 3.35% in the UK over the next 25 years. The austerity vs. stimulate debate partly hinges on the fear of deflation. By December, Japanese inflation-linked bonds showed markets expected prices in Japan to fall by an average 0.85% a year in the next decade. From the 1990s, Japan learned what about a deflationary spiral provoking ‘buying resistance’ among Japanese consumers. The deflation fear led to two interesting phenomena.

- Commonly, inflation is viewed as worrisome and to be avoided but a Japanese government promised to ‘inject some inflation into their economy’;
- Japan also provides yet another strange phenomenon. One of the costs of inflation is the slot machine cost – the cost of increasing the prices of automated slot machines. Of course this cost is lower than it used to be with sophisticated coin-taking (and now note-taking) dispensers. But with deflation, slot machines must also be recalibrated, downwards. Coffee machines were being reprogrammed to accept a lower charge for their beverages at the end of 2009.

Beyond default risk, the value of long-term bond is primarily determined by the expectations of inflation. If deflation is expected, the real value of debt is expected

to increase. This should lower the yield on bonds and encourage longer term investments. By December, an interesting trend had emerged. Long dated government debt (more that 15 years) had doubled as a proportion of total new debt in a year to 20%. The demand is not confined to government debt. China issued a 50-year bond and, in November, 30-year corporate debt was issued by Brazil's Petrobras. This theme was echoed in February when it emerged that China was shifting towards longer dated US debt. From a high of $801bn in Treasuries, its December 2009 holdings of $755.4bn looked worrying, particularly with a fall of $34.2bn in a month. However, $38.8bn had matured and $4.6bn had been used to buy longer dated paper. By then though, Japan had retaken the mantel of the largest holder of US Treasuries, lost in 2008.

Oil

One of the lessons from history is how important oil is to the global system. The price of crude oil, during 2009, was on average $62/ barrel. James Hamilton, the econometrician, suggested that, obscured by the recession is the likelihood that the oil price of $147 in 2008 helped transform a downturn into a recession. In other words, we would have entered a recession anyway, just the cause would be identified as oil.

It was estimated by the International Energy Agency that, in 2008, globally energy was subsidised by $557bn. If phased out, the consumption of energy, as measured in oil, could be reduced by 850m tonnes. In this era of strained Treasury budgets, governments cannot afford to continue to suppress oil prices. The IMF estimates that oil prices to the consumer will be subsidised to the tune of $250bn in 2010. Like many developing countries, India subsidises petrol and other petroleum products. The subsidy of petroleum products costs India about $16bn of which $11.7bn is for petrol itself. In June and July, India first deregulated prices, cutting subsidies and ending price controls of petrol. This would raise petrol prices by 8%, boosting inflation. The following week the RBI raised base rates by ¼%. Normally, such subsidies are to support the indigent, but the claim was that they were targeted poorly. A 12-hour strike on 5th July cost India and estimated $650m: a dozen of those and the cost of the strike may outweigh the benefit of removing the subsidy.

PwC suggested that the UK would be in a better shape than many OECD countries to bear an oil price increase. From February to April, oil rose by $15/ barrel. It suggested that a $10 increase in the equilibrium price would permanently reduce output by 0.75% for Japan and the US over 5 years; 0.6% for the Eurozone and 0.4% for the UK. The reasons for this are that the UK had a smaller manufacturing base, it produces oil itself, and the BofE can credibly hold down inflation.

Petrol Stationary

It is sometimes suggested that, to restrict the supply of petrol, oil companies deliberately under-invest in refining capacity. However, refining margins are slim. The peak margin in the last decade, $3.55/ barrel, occurred in 2005. The average has generally fallen to $2.79 in 2008 and $1.11 in 2009. Capacity utilization follows a similar pattern. In 2005, capacity utilization was over 90%, but by 2008 it was 81%. The poor performance has led to refiners to dispose of smaller, less efficient plants. One plant up for sale in April, the Stanlow refinery had the second high capacity at 267,000 barrels/ day. As reported in other *Updates*, the plants featured are ones subject to industrial disputes. The Lindsey plant, subject to wildcat strikes is also up for sale. A manifestation of the refinery problem occurred when the price of petrol was increased by 1p/ litre (with VAT = 1.2p) following the budget in March. However, according to the AA, forecourt prices rose by 2p putting it at 119.7p or unleaded and 133.25p for diesel. In their defence, the Independent Petrol Retailers suggested a 1p/ litre subsidy from refiners had been withdrawn, so the retailers were not extracting rent.

Moreover, these retailers were not profiteers. The number of forecourts, like pubs, is declining. In 1967, there were 39,958; in 2008, there were 9,263; and in 2009, the number was down to 9,013. They make 2p/ litre profit on petrol, so that, to survive, they need to sell other items in large volumes, probably suggesting 20-30 stations is the Minimum Efficient Scale for a group. They are struggling to survive.

The Small Trucker

Perfect Competition is often criticised by the new economist as an irrelevance as there are no real world examples. This may not be the point… however, the trucking industry does come quite close. Obviously, one barrier to entry is the capital needed to buy a truck, but after this the industry has favourable characteristics. Most of the market is dominated by small providers (Eddie Stobart has only 10% of the market). The 33,000 UK truckers make around 1.5-2% profit – more or less breaking even. Oil, which makes up 50% of running costs. The industry had seen a doubling of insolvencies, around two thirds freezing pay, and the same proportion had made redundancies in the year to March. In March, the Grocer reported that the price of bananas would rise above £1/kg as a result of rising freight costs of 8-9%. This adds 3.7p to a kg of bananas. As there is a freight transport supply glut, the price increase was, at around $80/barrel, driven by oil. In a perfectly competitive world, the trucker can do little but absorb higher cost of fuel, perhaps making a temporary loss, or leave the industry.

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