THE BUSINESS ECONOMIST

Volume 30 No 1 1999

WEATHERING THE INTERNATIONAL STORM
Willem H Buiter

ECONOMIC GEOGRAPHY REWRITTEN
David Owen

THE WEIGHTLESS ECONOMY IN GROWTH
Danny T Quah

Society of Business Economists

THE BUSINESS ECONOMIST

Journal of the Society of Business Economists (SBE)

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Subscriptions: The Journal is circulated free on publication to SBE members. Non-member subscription to Volume 30 Nos 1 - 3 1999 is £30.00 Europe, £35.00 airmail outside Europe, £12.50 single issue.

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ISSN 0306-5049
HGA Printing & Graphics Ltd Middlesex UB6 7JZ

THE BUSINESS ECONOMIST

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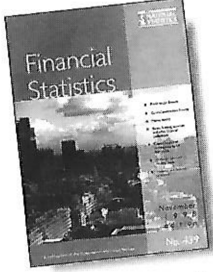

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EDITORIAL

The three articles in this issue of ***The Business Economist***, though each is full of interest, were not intended to have any particular theme, but as I read them together I think there is an affinity. Trading is one of the defining concepts of economics, and these articles offer, each from its own perspective, insights into the dynamic effects of that concept at work.

In the first Professor Willem Buiter examines, with a dry humour, the eruption of the Asian financial crisis in the summer of 1997 and of how, at least until October of last year when the article was written, the world had weathered the storm. This crisis is, he suggests, a common enough tale of unwise lending and borrowing encouraged by an uncritical economic optimism. However, it is also one bound up with the prolonged expansion of the global trading system, and the corresponding huge flows of funds between countries of every size and degree of economic sophistication. Many were weak in financial governance. When things went wrong their governments, short of foreign exchange and saddled with the overseas debts of bankrupt domestic borrowers, had to adopt restrictive fiscal and monetary policies, and *"the regional financial crisis had become a regional economic crisis."* And this crisis in Asia threatened to spread both directly through its trade links with the rest of the world, and by a wider flight to cash which might have damaged industrial and commercial activity generally.

Even when he wrote, Professor Buiter was able to note that these dangers seemed to have been averted, and to urge caution in any reforms of 'international financial architecture' to reduce the risks of such crises in future, although he does venture one suggestion of his own. Since then we have become blasé; observers see signs of recovery in Asia and the world's financial markets have shrugged off the Brazilian devaluation. But with Japan still in the doldrums and Europe scarcely fizzing the world has come to depend on the continued suspension of disbelief by US consumers in a stock market at incredible levels. We must hope it lasts, for it is hard to let down a bubble gently.

No bubbles in David Owen's thoughtful examination of the implications of EMU. He is concerned with the longer-term changes in industrial structure that will follow making a single economy of the EU. Observing

that industries are rarely distributed evenly across an economy, he expects the increased opportunities for trade after EMU to see the further concentration of particular industries into those parts of the EU which offer a comparative advantage to that activity. He goes on to report a study of the patterns of trade for particular activities within the EU as an indicator of comparative advantage in those activities, and concludes that patterns of advantage do differ markedly between member states and we must expect their economies within EMU to diverge rather than become more homogeneous.

Although the UK is not, for now at least, in Euroland, Mr Owen has included it in his study and his results confirm the conventional view that in general manufacturing is not our strong suit. And contrary to some, who have seen in the location here of several new Japanese-owned car plants evidence of renaissance in the British car industry, Mr Owen does not believe that UK trade patterns do indicate a comparative advantage in car making. The continued agonies of Longbridge offer doleful support.

However, he does find evidence confirming an advantage in financial and business services. There are those who suggest this advantage is such that the City will retain its pre-eminence even outside EMU, but many fear that if we stay outside too long our present advantages could be quickly lost as business and finance houses, many now in foreign ownership, move into the euro area. If the government's apparent tactics work, of a steady succession of preparatory initiatives and an accommodating attitude to use of the euro to make it more familiar and so to soften public opinion sufficiently to allow a successful referendum, we may never know. If familiarity instead breeds contempt and the government funks, or loses, a referendum we may find out quite quickly.

The financial service industry is one of those producing the 'weightless' products which Professor Danny Quah analyses in our third article. And, indeed, the UK seems to enjoy an advantage in many of them, and in particular in the creative industries, to judge by the recent ONS survey of service sector trade, which showed these to be among the fastest growing sectors of the UK economy. Professor Quah focuses on the economic implications of the essential feature of these products - that after the prototype they can be reproduced at near zero marginal cost. Moreover, the development of information technology has further distilled this essence by virtually removing the need for any physical embodiment of

the product. He explores some of the arrangements used to make trade in such products possible - from bundling with other goods or services to use of patents or copyright - but warns that their winner-takes-all dynamic may have less than welcome distributional consequences.

We have a comment from Ulric Spencer, pursuing the debate on economic statistics, which considers the report of the Treasury Committee on the ONS. He notes that the Society's submission was among those published in Evidence, and that the Committee endorses the Society's concern about the damaging effect of too many attempts at cost cutting. Whether the report will do any more to promote an independent statistical service than the Green Paper is a moot question. This government seems reluctant to give up control of any information.

Speakers' Corner reports Bill Dudley from Goldman Sachs who spoke to the Society in October about the prospects for the US economy. He was sanguine that a modest slowdown would be contained by lower interest rates, but acknowledged the risk of a worse outcome. It is not the most reassuring basis on which to face the difficulties described by Professor Buiter. In January Howard Davies spoke of the economic reasons for financial regulation in a market economy. They did not, he said, include promoting the reputation of the UK financial services industry. There are, too, our Book Reviews, here noticing studies of the nature of economics and its relation to other social disciplines, work on the productivity issue and on competition and regulation.

One last word. In this issue we publish a memorial to Tad Rybczynski who died at the end of last year. He was a seminal figure in the development of our Society, but he also gave great encouragement to all who practised economics in business. I was one of many who appreciated his enthusiasm. On behalf of all of us may I say how much he will be missed.

Jim Hirst

Editor

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Weathering the International Storm[1]

Willem H Buiter[2]

During the middle of 1997, when the Asian financial crisis first struck, the world economy appeared to be in reasonably good shape. World GDP growth had been running at about 4 per cent per annum since 1994. World trade had been growing at over 9 per cent per annum since 1994, with just a slight dip to 6.8 per cent in 1996. Employment in the advanced countries had been growing at 1 per cent per annum since 1994, with much higher rates achieved by the newly-industrialised Asian countries. Inflation in the advanced economies was declining gently from 2.2 per cent in 1994 to 1.7 per cent in 1997. Fiscal deficits in the advanced countries were coming down.

The US was in the sixth year of continuous expansion. The UK had recovered from the recession of 1991/92 and had achieved high levels of capacity utilisation. Growth in the future Euro area was steady but below that achieved by the US and the UK, and employment in Euroland was growing only very slowly after 1994. The newly industrialised Asian economies and the developing countries were growing at annual rates above six per cent.

Not all was well, of course. Growth in Japan was well below the rates achieved in the 1980s and significantly below the rates achieved by the other industrial countries.

Stock market valuations throughout the world seemed to have become detached from reality. It was a tour de force to come up with plausible numbers for expected future corporate earnings growth, risk-free real rates and equity risk premia that could rationalise observed price-earnings multiples. In the US the unemployment rate had fallen below any past estimates of the natural rate and growth was systematically outstripping

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[1] Remarks made during an address to the Society of Business Economists on 25 November 1998. The opinions expressed are those of the author only and do not necessarily represent the views of the Bank of England or of the other members of the Monetary Policy Committee.

[2] Professor of International Macroeconomics, University of Cambridge and Member, Monetary Policy Committee, Bank of England.

most estimates of the growth of potential. Similar behaviour characterised the UK economy.

Reinforcing these worries was the increasingly common talk in the US about a 'new paradigm'. The spread of information technology had, according to the apostles of the New Age, raised the sustainable growth rate of GDP by a significant amount. Labour market flexibility, including the steady decline in unionisation rates and other Reagan-era reforms had lowered the natural rate of unemployment. The only threat to the promise of unbounded growth opportunities was an insufficiently accommodating monetary policy.

As a rule, when the experienced investor hears words like 'new paradigm', 'new era', 'the death of the business cycle' or similar techno-babble, the only wise course of action is to take one's money and run. It is typical end-of-expansion hype. Market analysts and traders, whether driven by self-interest (outstanding bets on a rising market) or by amnesia and herding instinct, drive asset valuations to awesome and unsustainable heights.

A very long, sustained period of boom has other destructive consequences for financial stability. Loan appraisal and vetting standards are relaxed. Insufficient attention is paid to credit risk, counterparty risk generally and, when a sustained stock market boom is perceived as the normal state of affairs, even to price or market risk. The quality of the portfolios of banks and other financial institutions deteriorates.

Nowhere was this slippage in the normal standards of financial prudence more blatant than in the lending to the emerging market economies.

The financial crisis that struck Thailand, Korea, Indonesia and Malaysia was, in the first instance, a crisis of governance rather than the result of blatant macroeconomic mismanagement. The fiscal aspects of the crisis were there, but indirectly and less transparently than usual.

Undisciplined lending over a number of years by foreign financial institutions, undisciplined borrowing by domestic financial intermediaries and by non-financial corporations directly, had resulted in extremely fragile financial balance sheets throughout the emerging market economies that were struck by the crisis. The tale of inadequate governance, regulation and supervision in the borrowing countries has been told many times, and I will not go into any detail here. Lack of

transparency, crony capitalism, corruption and the perception of a high likelihood of a government-financed bail-out should things go wrong, all contributed to the build-up of bad private debt. Governments, partly blinded by the phenomenally high growth rates and the massive investment and construction programmes that cluttered the landscape and their vision, and relying, in the small hours of the night, on the likelihood of an internationally orchestrated bail-out should they ever find themselves strapped for funds, encouraged the borrowing frenzy. The mantra of 'Asian values' played much the same role in some of the Asian economies as that played in the US by the 'new paradigm'.

Inadequate governance likewise characterised the behaviour of the lending institutions, however. No lessons appear to have been learned from the debt crisis of the early eighties, let alone from the earlier debt crises of the period before World War II. The fact that, unlike the lending boom preceding the Mexican crisis of 1982, much of the 1990s debt took the form of bonds rather than bank loans was often, and erroneously, asserted to make a qualitative difference. The regulated international lenders clearly failed to monitor the risks they were taking on. The further complication was that a large number of unregulated financial intermediaries (I shall call them hedge funds) were taking very large open positions in emerging market debt. These institutions are unregulated, unsupervised and their operations are clouded in secrecy.

What began in July 1997 was a regional financial crisis. Regional governments found themselves short of foreign exchange and saddled with a large amount of contingent liabilities - the bad debt of the bankrupt domestic private borrowers. The first domino in the bail-out sequence had fallen. A corporate governance crisis had become a fiscal problem. For a while, until the Russian default in August 1998, the second domino, the international bail-out, also tumbled when expected. The borrowing countries did pay a heavy price however. Highly restrictive monetary and fiscal policies were implemented (often under IMF programmes) and real activity went into a severe downturn. The regional financial crisis had become a regional economic crisis.

The regional economic crisis contributed to a global economic slowdown, mainly through the real trade linkages between the crisis-torn Asian countries and the rest of the world. The total impact however, was relatively small. Even a mild recovery in Japan would have more than offset the trade impact on the industrial countries outside Asia.

Then, in August 1998, a domino failed to fall. Russia was not bailed out and reneged on its domestic TB debt, a large part of which was held by foreign financial institutions.

An illustration of the lack of foresight of the international lending community is the fact that a large part of the foreign exchange risk attached to these holdings of Russian GKOs had been 'covered' in the forward markets. The counterparties to these forward contracts, however, tended to be the same Russian banks that were not performing on their debt. Market risk was covered by adding perfect positively correlated counterparty risk.

Whereas up to the Russian default the only spreads that had been affected seriously were those paid by the crisis-affected emerging market economies, now spreads widened across the board. A country like Argentina found its spreads raised by 1000 basis points. Brazil faced even larger increases. Within Euroland, spreads between sovereign debt instruments denominated in different national currencies widened. Those who had made large (and very highly leveraged) bets on a further narrowing of Euroland spreads, took a massive loss. The most prominent victim was the inaptly-named Long-Term Capital Management (Short-Term Capital Mismanagement would have been more appropriate).

Spreads now widened throughout the financial systems of the advanced industrial countries. Within the domain of US and UK sovereign debt, the flight to quality went to the point of becoming a flight to the short end of the maturity spectrum. The inversion of the yield curve was reversed. Even the spreads between 'on the run' and 'off the run' TBs widened. We were witnessing a liquidity crisis and disorderly markets.

The main threat was that this global financial instability would spread to the interface of the financial sector and the industrial, commercial and household sectors. A corporate credit crunch looked like a distinct risk, especially in the USA. Stock markets fell significantly and consumer and business confidence took a severe beating. In the UK this was reinforced by a slowdown in growth that was partly due to the Asian crisis and partly to the strength of sterling since the summer of 1996 and the monetary tightening that had been under way since May 1997.

Since September, the news has by and large been good, in the sense that there has been no further bad news. Short-term rates throughout the industrial world have come down. The only exceptions have been the D-

mark zone of Euroland[3]. The financial instability has been contained largely within the financial sector, and even there spreads have been halved since their peak. There have been no new large victims of indecent financial exposure. There is no evidence in the UK of a credit crunch affecting commercial, industrial and household borrowers. Long rates have fallen further and the stock markets have recovered to their pre-Russian default heights.

Cautious optimism is not the same as confidence that all now is well, however. The Asian debtor countries have suffered very large declines in output. They will have to export their way to recovery. This requires a corresponding increase in the trade deficits of the industrial countries. Ideally, the distribution of these increases in industrial country trade deficits (and the associated changes in real exchange rates) would be distributed among the main players according to the phase in the business cycle they are in. This would imply a larger trade balance increase for Euroland and smaller increases for the US and the UK. The international competitive environment will continue to be very tough for exporting and import-competing industries throughout the industrial world. The UK will be no exception.

Japan continues to be a major drag on global economic performance. There is some hope now that the large-scale financial restructuring that has been required at least since the beginning of the decade, may now be gathering pace. This is a precondition for getting the country out of its 'liquidity trap'. Aggressively expansionary fiscal policy will also be required. Much has been promised, repeatedly. Little if any has been delivered so far. One hopes for the best.

The US economy continues to expand apace. While this is welcome in the short-term, there has to be serious concern about how long this can continue without generating significant inflationary pressures. Stock market valuations are again at levels not seen since the Tulip Mania. If this is a bubble, as I suspect, it will burst. We can only hope that when it bursts, the financial system and the real economy will be in the optimal condition for coping with this destruction of wealth.

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[3] Written before the co-ordinated cuts in rates to 3% on 3 December 1998 in all Euroland countries except Italy.

In Euroland, growth continues at a reasonable pace, but there is concern (as reflected in falling business and consumer confidence and in declining export orders) that too much will be asked of domestic demand there to keep the recovery going. There are key uncertainties. Uncertainty about the future strategy and tactics of the ECB; uncertainty, about the amount of fiscal flexibility remaining under a strict application of the Stability and Growth Pact; uncertainty also about the possible consequences of a relaxation of the fiscal criteria (favoured by the new left-of-centre continental European governments) running into a European Central Bank with a clear price stability mandate and a need to establish a reputation for not being pushed around.

In the UK the fundamentals seem right for a moderate slowdown that keeps inflation on target without any descent into economy-wide recession. However, the economy is a very heterogeneous collection of regions, sectors, industries and firms and the prospects for the internationally-exposed sectors of the UK economy, both manufacturing and internationally-traded services, are not easy for the next year or so.

Yet, overall, corporate balance sheets are healthy; there is no evidence of a credit crunch, nor is there evidence of an overheated housing market or of an unsustainable construction boom. The stock market, however, again appears 'generously valued'. When the inevitable correction comes, demand will be dampened. Consumer and business surveys are almost uniformly dismal, and the reports from the Regional Agents of the Bank of England confirm the other evidence of an across-the-board slowdown.

The Bank is fully aware that its inflation mandate is symmetric. Inflation outcomes below 2.5 per cent are as much a failure as inflation outcomes above 2.5 per cent. In light of the news since August 1998, we therefore have cut our rates by 75 basis points. We will move resolutely, in either direction, if we believe that the balance of risks to the inflation target requires such actions.

Globally, central banks are doing the right thing. Interest rates are being cut, sometimes quite aggressively, across the industrial world, again with the exception, thus far, of the DM zone.

On the fiscal side, it is vital that governments let the automatic stabilisers do their work, should growth turn out to be lower than expected. The Chancellor has made it clear that this is exactly what he intends to do. I have no doubt that in the US also, counter-cyclical deficit increases will

be accepted should a slowdown occur. In Euroland, there is the unresolved question of the amount of fiscal elbow-room available to those countries that are close to their Maastricht or Stability and Growth Pact ceilings. The historical record of the Bundesbank suggests that a staunch anti-inflation ethic is quite compatible with a flexible monetary policy that is supportive of real activity, as long as this does not jeopardise the inflation objective. There is no reason why the ECB should act differently.

As regards international financial architecture[4], it is best to be modest. Target zones for exchange rates between the major currencies are, I believe, a non-starter, if only because the Americans are not interested. Exchange rates are an important part of the international transmission mechanism. Exchange rate volatility and misalignment can be a source of economic dislocation, but the record of co-ordinated exchange rate management does not inspire confidence.

Nor are blanket controls on international financial capital mobility the way to prevent overlending, overborrowing, foreign exchange crises and international liquidity crunches, although some developing countries and emerging market economies may well wish to impose selective controls on capital inflows in the absence of a strong domestic financial system. Indeed, enhanced domestic supervision, regulation and transparency are essential everywhere, as is the need for a depoliticisation of economic relationships generally. Hedge funds and other international betting shops are best tackled by closer regulation of those regulated and supervised institutions that supply them with funds. Bail-outs of non-regulated institutions should be avoided. If bailouts are deemed necessary because the institution in question is 'too big to fail', the *bailer* should ensure that all *bailee* insider equity is wiped out, and that the managers of the bailee funds have severely restricted career prospects in the financial sector. Even the appearance of conflict of interest (say because the managers of the bailers have personal stakes in the bailee) should be avoided.

In conclusion, while the world economy is not in the best possible shape, it is in better shape than we could have expected in September, and in significantly better shape that the doomsayers among us would have us believe. Policy makers do learn from past mistakes. The best guarantee

[4] Jointly with Anne Sibert of Birkbeck College, I have proposed a possible solution to one aspect of international financial crises. A brief summary is given in Appendix 2.

that there will not be another Great Depression is that there has been a Great Depression, and that we have learnt the lessons.

Appendix 1: Discussion at the meeting

The discussion after Professor Buiter's address focused on the consequences for policy in the US and Europe. A central concern was the viability of the US deficits - on trade account and in the private sector - which were seen as vital to giving the world economy time to rebalance.

Professor Buiter agreed that there was a risk that the trade deficit, if too great or prolonged, could become dangerously sensitive politically. Moreover the private sector financial deficit did look vulnerable to a collapse on Wall Street but Professor Buiter argued that the present bubble in the US stock market was not amenable to a policy of gentle deflation. However, the Federal Reserve could seek to preserve orderly markets even if not a particular market level, and, he pointed out, a stock market crash need not always precipitate a collapse in the real economy. *"Acts of monetary heroism"*, he said, *"can have a large impact on confidence."*

From the Asian side of the problem he agreed that a weak yen could be a part of a Japanese recovery, but believed that stronger domestic demand had to provide the main stimulus. He could think of no reasons for the pick up in the yen in the summer, other than a thin and nervous market, but he believed a floating exchange rate regime was more survivable for most developing countries than the costs and risks of attempting to peg rates. In the case of Brazil he suggested that the least bad policy would be to lean against, but not seek to prevent, a fall in the exchange rate. However, he warned that to devalue without an appropriate monetary and fiscal strategy would be pointless.

Asked about the danger of a deflationary bias in European monetary policy which would aggravate the impact of the crisis in the Far East, Professor Buiter stressed again that the objective of UK policy was symmetric, and required action if inflation fell below the target level, as well as when it went above it. In Euroland, while the wording of the inflation target set by the European Central Bank was not as clear as it might be, he believed that it implied a willingness to ease monetary policy if inflation fell to zero or prices threatened to fall. He reiterated

that its exemplar, the Bundesbank, had in practice been more flexible in its policies than was generally supposed.

Finally, he agreed that reforms to the structure of the economy might well be worth pursuing, but most were not relevant to the management of cyclical disturbances or crises. Reforms to the governance of financial institutions or tax reforms to improve the effectiveness of fiscal stabilisers could be helpful.

Appendix 2: UDROP or You Drop

A Small Contribution to International Financial Architecture - A Summary[5]

Willem H Buiter and Anne C Sibert

A problem similar to a liquidity crisis at an otherwise solvent bank can confront a country if its residents have short-term foreign currency loans secured against domestic currency assets, and the country's foreign exchange reserves are insufficient to cover all these foreign currency liabilities if creditors seek repayment, even though these loans could be serviced in full if rolled over. The problem will be made worse if the run drives down the exchange value of the domestic currency creating an imbalance between foreign currency debts and domestic currency assets and leading to insolvencies.

Of course, countries can try to limit these risks. Borrowers of foreign currency can be encouraged to match assets and liabilities better. Regulation can aim to match the private and social costs of taking unhedged foreign currency positions. A central bank can take steps to maintain the value of its currency, but to do so, in a crisis, it may have to raise interest rates to extraordinary levels and the inevitable damage means this is rarely a fully credible policy. Help can be sought from international financial institutions, but these can rarely act quickly enough or, indeed, have the resources to be effective.

[5] A full exposition of this proposal can be found on Professor Buiter's website at **www.econ.cam.ac.uk/faculty/buiter**

For these situations we therefore propose a **universal debt roll-over option with a penalty (UDROP)**. All foreign currency lending would be required to have a roll-over option which would entitle the borrower to extend a debt at maturity for a specified period at a penalty rate, sufficient to make it an unattractive option in all but critical situations, and for further periods at still higher penalties.

Obviously this proposal would only solve the problems of a debtor who cannot roll-over debt in the market because of a liquidity crisis but is otherwise solvent. It must be universal or the very request for such an option would be taken as a sign of impaired credit-worthiness. It has also to be automatic, at the discretion of the borrower, and without the need for time-consuming assessments by international agencies, or the damage will have been done.

International co-operation would of course be needed to make the UDROP scheme mandatory. This might be achieved by an agreement among BIS members to make foreign currency debt contracts without the roll-over option unenforceable in participating countries' courts.

The scheme should not involve large administrative or enforcement costs. It may impose a penalty on a borrower whose likelihood of excercising the option is overestimated by the market, while borrowers whose likely use of the option is underestimated may get a subsidy. There will be no burden on those seen as virtually certain not to need the option, as an option that will never be excercised is worthless and has a price of zero. The scheme should certainly compel the markets, in pricing these options, to pay serious attention to the risks of a liquidity crisis and that, in itself, would make a significant contribution to global financial stability.

Economic Geography Rewritten

David Owen[1]

Introduction

EMU should hasten the move to greater industrial specialisation across the regions of Europe. Greater trade links will enable more European companies to take advantage of the economies of scale that a large single market makes possible. This has been the experience of the US, an economy of a comparable size and population to that of the newly created Eurozone. As a result industry in the US is substantially more geographically concentrated into centres of excellence than that of Europe.

Individual European economies will become more proficient at producing fewer products. This may eventually bring with it stronger economic growth, but will create clear winners and losers. This is not just about large companies becoming larger through mergers and acquisitions and organic growth. It could just as easily be the result of a large number of small companies clustering together.

Everything being equal, it will be the country which has a comparative advantage over the rest of Europe in producing each product in question which will benefit from the greater economies of scale post-EMU. Small initial differences could translate into substantial long-run differences.

Trade flows may say nothing about the ownership of capital; they can be distorted by regulatory or fiscal regimes; the figures look back in time and they do not distinguish between quoted and non-quoted companies. Nevertheless, they do say something about comparative advantage, and in this article we have analysed trade data within the European Union to uncover the patterns of advantage which are emerging.

Conventional wisdom is that much of the core of Europe is industrially relatively similar. However, the work that we have done suggests that

[1] Director, Dresdner Kleinwort Benson