

KÖNIGSWINTER

The British-German Conference

SEVENTH ANNUAL ECONOMIC KÖNIGSWINTER CONFERENCE

Friday 10th November – Saturday 11th November, 2006.

**Ditchley Park, Enstone, Chipping Norton
Oxfordshire OX7 4ER**

'Shifting Global Balances?'

Bilateral dialogue once again proved to be of value as a senior Group of German and British business people and officials met in the glorious autumn surroundings of Ditchley Park. Many of the Themes of past Conferences recurred (British feelings of success – much more tempered perhaps, this year; German complaints about lack of domestic leadership and the paralysis of the political system), though the tone of deep German gloom seemed to have lightened considerably since the previous Conference.

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The conference proved timely since it was held only days after the Republicans lost control of Congress in America's mid-term elections. That decisive vote opens a new chapter in politics and foreign policy after the one written by President Bush since the terrorist attacks of September 11th 2001. But whatever direction that narrative takes, politicians and businessmen in the United States and in Europe will continue to grapple with shifting global balances – the theme of the conference – as a new economic firmament comes into being.

China is the brightest rising star of that firmament and its brilliance preoccupied many speakers. If China was to be the manufacturer, India the office, the Middle East and Russia the petrol station, where did that leave Europe? But that would be to underestimate Chinese economic ambitions, which extended far beyond low-cost manufacturing.

China's voracious appetite for energy and raw materials was a crucial reason for the three-year surge in oil prices, which had created another major shift in the global balance of power, notably the renewed clout of Russia because of its gas reserves. For its part, China was flexing its economic and financial muscles in the developing world by striking deals with resource-rich countries. And, with its foreign-exchange reserves now exceeding a trillion dollars, not only did China exert power in the currency markets, but also that war-chest would increasingly be used in foreign acquisitions of companies rather than further accumulation of Treasury bonds.

China's rise conformed with the logic of globalisation whereby cheap labour is being brought on to world markets on an unprecedented scale. But it flouted the logic whereby capital is supposed to flow downhill to poorer countries rather than uphill to finance

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excess spending in rich nations. That logic, however, was certainly being pursued by western investors, whether in private equity or more generally in finance, who were methodically searching for higher return on a global basis. The potential was all the greater now that China could not only offer cheap labour but also match the highest standards of production.

How well placed were Germany and Britain to adapt to these global shifts? After a long period of poor growth, the German economy was at last doing better. Export performance was exemplary and German companies had made great strides to restore their competitiveness by cutting costs including deals with workers to raise their working hours. Investment was picking up and a recovery in tax receipts was pushing down the budget deficit. A shake-up in Germany's corporate-tax system was planned.

Despite these positive signs, several speakers remained sceptical about Germany's ability to respond effectively to globalisation. Although a fall in real wages showed greater labour-market flexibility, the Hartz reforms had not done enough to get the long-term unemployed back into work. There was a lack of entrepreneurial spirit, a desire for a job for life and a mindset that still looked to the government to cocoon workers from the pressures of the marketplace. The row over Grohe during last year's election when private-equity investors were called "locusts" demonstrated a continuing reluctance to accept the lessons of globalisation. There was a general sense of disappointment at the performance of the coalition government, which had allowed itself to be distracted from the bigger economic picture by the lengthy pursuit of a rather limited but over-elaborate health-care reform.

By contrast, most speakers agreed that Britain had already shown a superior capacity to adapt to globalisation. Its sparkling growth record over the past 15 years spoke for itself. The painful labour-market reforms of the 1980s had paid off in the 1990s through a sustained decline in structural unemployment. Britain had also benefited from its earlier shake-out of industry 25 years ago so that it was less vulnerable to the challenge of China in manufacturing. Meanwhile its big financial sector was flourishing as globalisation fostered growing demand for the specialist international services that are clustered in London. Entrepreneurial drive was more in evidence than in Germany and young people did not expect a job for life. There was little objection to Britain's much bigger private-equity industry on grounds of employment. The main worries that had recently been aired were regulatory ones, and for example the risk of excessive leverage.

There were some concerns, however, about whether this broadly satisfactory response to globalisation would be sustained. After surging in the late 1990s, Britain's business-investment performance had been lacklustre. Employers were unhappy about the extra burdens of labour-market regulations that had been heaped on them in the past few years. Non-wage costs had soared recently as a result of extra company contributions to deal with pension scheme deficits and the minimum wage had risen steeply in the past four years. Britain had slipped from having the third lowest corporation-tax rate in the EU15 in 1996 to the tenth in 2006. Despite the long fall in the jobless rate (which in the past year had started to rise again) over 2.5 million working-age people were drawing

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incapacity benefits, a group that included many really unemployed rather than unable to work.

The failure of the Doha trade round in July suggested a faltering appetite for further globalisation in the developed world. Some speakers felt that it was urgent to resuscitate the trade talks: the possible benefits to the world economy ranged from \$500 billion to \$2 trillion. However, the prospects looked bleak especially since American workers and politicians were starting to link the stagnation in real income for middle earners with globalisation. Europe was hardly likely to take a lead given the reluctance of France to make concessions over agricultural support.

But did the failure of Doha really matter that much? A majority of speakers felt that it did not as long as it did not portend a revival of protectionism. Clearly it did matter for Africa, which is why Doha had been called a development round. But for the global economy as a whole, agriculture – the main sector affected - was too small to have much bearing on its direction. Furthermore, there was some hope that the revival in agricultural prices and the opportunities of biofuels might provide an opportunity to reduce support to farmers without an explicit trade round.

The forces driving globalisation remained powerful enough with or without the assistance of Doha. For example, western companies would continue to exploit the advantages of outsourcing production to foreign suppliers and to offshore services to overseas providers. Typically, outsourcing started as a means to cut costs but companies then found there were other further gains such as in improving their supply chains. Much of such activity took the form of direct investment by companies setting up and investing in subsidiaries in cheaper-labour locations. But they in turn were increasingly being driven by the growing clout of private-equity firms, whose role was the next subject of debate.

The conference learned that private-equity firms were operating on an increasingly global scale, looking for opportunities in Asia as well as the United States and Europe. Private equity had shifted in the past six or seven years towards a much greater operational involvement in the companies acquired. It was driving better performance both within those firms and more generally because of the threat of such acquisition to under-performers.

This claim aroused a certain amount of scepticism. Although the charge of “locusts” was ridiculous, some worried about the juxtaposition of job losses in companies acquired by the industry and the big personal gains that could be made in private equity. Others argued that the industry was focused on short-term financial gains that might injure companies’ long-term health. Attitudes towards the industry had become less favourable in Britain; and its boom might itself be a bubble.

These charges were vigorously rebutted. The industry did not and could not rely on public-equity investors playing the “greater fool” when companies were resold on stockmarkets, yet this was the only way in which short-term financial restructuring at the expense of longer-term prospects could be made to work. Far from being a bubble, the

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growth to date represented only the early stage of its potential. However, the industry had a poor reputation and in response it would have to accept that private equity could no longer be private and must come out of the shadows. Was the success of private equity also a failure of stock markets, which had previously played their role as catalyst for change and increasing efficiency? It was a questionj that remained unanswered.

In its final session, the meeting explored the possible limits to globalisation. The rapid industrialisation of China and other developing economies had pushed up the prices of many raw materials as well as oil and gas. This in turn had highlighted the extent to which many of these were concentrated in a few countries, such as Russia's share of gas reserves and Niger's grip over uranium. How vulnerable might the world economy be to such monopoly providers of essential commodities?

One view was that businesses were much too complacent about such risks, especially given the historic shortfall in investment in natural resources. But others argued that these concerns would prove as ill-founded as the alarm about "limits to growth" in the 1970s. Higher commodity prices would spur more exploration for conventional fuels while also creating powerful incentives to develop alternative sources of energy. China itself was planning to generate much more solar and wind power.

The most plausible scenario seemed to be one in which pressures on natural resources would slow but not stop global growth. A bigger worry was that there was indeed a natural constraint on growth – the amount of carbon that could be emitted without disrupting the world's climate.

Speakers thought that international terrorism was both a reaction to and another possible drag on globalisation. One plausible explanation of Islamist terrorism was that it represented a response to what was seen as the cultural attack of the western way of life. Despite the threat of further atrocities, for example through a "dirty bomb", the most likely scenario was that it would brake rather than stop globalisation. Higher security spending would raise taxes but societies would manage to cope with this new kind of terrorism.

November 2006.