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ECONOMIC NEWS UPDATE

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There are two ways to make policy. One is on the hoof, and in search of headlines, as the President did in this week's State of the Union message. Just as oil prices started to ease, he gave a gift to Hugo Chávez and the Saudis by announcing plans to double the size of the Strategic Petroleum Reserve (SPR). That produced a 5% increase in oil prices, the biggest one-day jump in over a year. And to make certain that corn growers in Iowa will look favorably on the Republicans in 2008 he announced a huge and unattainable increase in ethanol production, driving corn prices through the roof, to the cheers of the nation's agribusinesses and the moans of poor Mexicans who are struggling to pay for their next tortilla. Worse still, the President's love affair with ethanol has set off a wave of deforestation to clear land for corn -- not exactly the way to reduce carbon emissions.

The other way to make policy is to build on ideas. "If you want to affect policy, start a magazine", the godfather of neoconservatism, Irving Kristol, once told me. He should know: articles in his Public Interest laid the basis for the

welfare-to-work reform finally signed into law by President Clinton, and the "broken windows", zero-tolerance policing that Rudi Giuliani and others put into practice with the result that America's cities became livable again.

So if you want to know the future direction of policy in America, you can bet on two things. First, ad hockery is no route to success. Calls for "energy independence" based on building an SPR that the government has never figured out how to use, or on turning forests into corn, won't work. Higher petrol prices would, but that's an idea neither the President nor his Democratic opposition is prepared to debate with its proponents.

Second, count on the ideas that are now only starting to be debated to make the running in the long run. The first idea ready for debate is the effect of regulation on the preeminence of America's financial services sector. Picture this: Eliot Spitzer, the scourge of Wall Street, standing beside New York Senator Chuck Schumer and Mayor Mike Bloomberg to fire the opening shots by unveiling a McKinsey report warning that London is on the way up,

and New York on the way down, while a worried former Goldman Sachs head and now Treasury Secretary Henry Paulson joins the battle on the Washington front. Financial services employment in London is up 4.3% in the three years to 2005, while New York City's fell by 0.7%. Total employment in this sector now stands at 318,000 in London and 328,000 in New York. Unless New York becomes more competitive, 60,000 of those jobs will be lost in the next five years. By last year American exchanges' share of the world IPO (initial public offerings) market had fallen to one-third of its 2001 level. So say the McKinsey consultants.

The idea to which these data have given impetus is that regulation must be relaxed and the "expensive and unpredictable" legal environment changed. Reflexively anti-regulation Republicans are joining New York Democrats Schumer and Hillary Clinton, new to the cause of reducing government intervention in markets, in trumpeting the need for change. But for their idea to triumph, they will have to answer questions so far avoided.

Why is it that Wall Streeters, the advocates of ever-freer trade for others, turn first to government when hit by foreign competition? Might it be because they do not want to lower their fees, which are substantially above those charged in London, just as makers of trainers and t-shirts have had to cut prices to meet foreign competition? Do the deregulators really want to return to the good old pre-Sarbanes-Oxley days when board-member-chums-of-the-CEO set compensation for their pal and benefactor, rather than leave in place regulations requiring board members to be independent? Does the fact that 64% of US companies listed on AIM (the

market for smaller companies) are selling below their float prices not suggest that the movement to the City from Wall Street by companies of this sort is a plus for the US, rather than a minus? And isn't competition from London and other overseas exchanges the reason the New York Stock Exchange is rushing to have all of its 3,618 listed securities traded electronically and more efficiently than by old-time floor brokers, now being laid off in large numbers?

Even more important, those rushing to ease what they see as the regulatory burden on the financial services sector have to confront academic studies that suggest that the relative decline of New York is due to the improvement in the depth and transparency of other markets, and to regulatory regimes that have cleaned up abuses formerly characteristic of many overseas markets. Finally, there is that great question: so what? Former Treasury Secretary Larry Summers points out, "Well-functioning capital markets are central to the success of the economy. What fraction of capital markets transactions runs through New York is of much less broad-based significance."

Although these questions and points remain unanswered, the anti-regulation crowd seems to be winning the day so far, to the delight of traditional anti-regulation conservatives. But conservatives' joy is somewhat mitigated by the fact that they are trailing in still another battle of ideas. It is established conservative doctrine that the free market allocates incomes in proportion to the contribution each player makes to the material wellbeing of society. But that idea is now being challenged by liberals who have long

been searching for a set of ideas to support their egalitarian leanings. They have found just that set.

Markets, they argue, have nothing to do with executive compensation. Just look at the way directors have acquiesced in the backdating of options (including their own), including in at least one case the options of a deceased executive, in no position to respond to any new incentives. Or consider the golden goodbyes that failed CEOs receive on the way from the executive suite to the golf course. Compensation unrelated to performance, or to rigorous control by directors, surely cries out for government control, argue politicians who have never considered that their particular cure might be worse than the disease. So the Democratic-controlled Senate Finance Committee has approved legislation to limit use of tax deferrals, raising the tax bill of executives by over \$800 million. That is only the first step on the road to control of executive compensation if the equalizers win this war of ideas. Unless, of course, the private sector takes ownership of the problem, which it might well do. A dozen international shareholder groups, with \$1.5 trillion under management, have asked that governance rules be changed require what the Financial Times calls “a UK-style non-binding shareholder vote on executive compensation packages.

Finally, an ideas war that will dominate policy-making relates to global warming. One battle in that war is over: whether or not the globe is warming, whether or not that warming is the result of human activity, from now on policy will be made on the assumption that the earth is getting hotter, and that our driving, flying, heating and cooling is the

cause. The next battle will be over whether markets can be created to reduce emissions, or reliance must be placed on direct government restrictions on emissions.

Which is as it should be: ideas matter, and the best ideas are those that survive the give-and-take of serious debate.



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