Block 2 The Building Blocks of Performance Measurement

Unit 6 Evaluating financial and economic performance
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Unit 6   Evaluating financial and economic performance

Prepared for the Course Team by Richard Wheatcroft

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Aims and objectives

After studying this unit, you should have:

- A better understanding of how financial accounts are used.
- Some insight into the effect on financial performance measurement of varying accounting standards across the European Union.
- Skills in analysing the implications of macro-economic events.
- More knowledge of two major examples of macro-economic events.
1 Introduction

This unit is broader in scope than much of that which has preceded it, and of some that will come in Block 3. At times we must take a broad-brush approach to some of the factors affecting our managerial lives. Broad tends to mean less deep (but not shallow), and one of the skills you need to acquire and hone is to assess what level of detail is required and cost-effective in particular circumstances.

You will start by considering some of the implications for all managers of the way in which financial performance is measured and published. To evaluate performance you must be able to understand the way in which it is measured – and that measurement must itself form a reasonable representation. In Unit 2 we discussed the importance of using an appropriate yardstick; much of the difficulty with measuring financial performance meaningfully is finding the balance between a system that is accurate but opaque and one that is usable but imprecise. An analogy would be the difference in medieval times between the King's cast bronze Yardstick, lovingly forged and kept in the Tower of London, and the rough copy sent to every town hall.

This is not an accounting or a finance course, so the treatment is mostly at a generalized and conceptual level. The technicalities of direct financial performance measurement were covered in the prerequisite accounting course or module (i.e. B785/795/655 or B600 and B700 if you followed the Diploma route, and B880/800 if you came direct into the MBA Programme). Knowledge of such ideas as ratio analysis and cost-volume-profit analysis is assumed here.

Activity 1

Satisfy yourself that you still remember the concepts of ratio analysis, etc. from your past accounting studies. It is not necessary, for example, to recall exactly the calculations for ROCE, AUR, ROS, but you should know what each is useful for and how they fit together. A good immediate test is to reassure yourself that you can remember what the three acronyms stand for, and how they interrelate.

The accounting aspects of financial performance are covered in the first section of this unit. The running theme will be the need to develop an understanding of the boundaries and limitations of financial performance measures. Any form of information must be considered within the context in which it was produced or it may send out misleading signals. Thus the financial discussion should lead to a better understanding and use of the measures you have already met in previous studies rather than to a major extension of the 'numbers portfolio'; for most managers the range of measures you have already met is sufficient – provided they are used effectively.

However, this unit will touch on expansion of your measures portfolio in one area. In the prerequisite accounting material the indicators used were, primarily, generic items such as Return On Capital Employed (ROCE) or Return On Equity (ROE). While important, these general measures should be joined by others that are also very meaningful, but only for and within the organization that produces and uses them. A check-list of necessary attributes for such performance measures is discussed in Section 2.4.

We will then look at topics that are still broader in scope and loosely referred to as 'macro-economic policy' matters. In the remaining sections of this unit you will be concentrating rather more on the 'economic' aspects of the title than on
the 'financial' ones – although the two are inextricably linked. The style of working will also be somewhat different in that the main text will consist principally of descriptions of the implications of and arguments for and against two topics which will continue to be of major importance for our business and personal lives. You will be asked to consider the points put forward and to gather more up-to-date facts at the time of your study, and to estimate the likely impact on your situation, and what you should be doing to optimize the results.

The two topics we will be looking at are:

- European Monetary Union (EMU)

and

- pension provision and demography.

**Activity 2 – Continuous**

During your study of this unit, collect any articles you come across in the newspapers about the two topics. Particularly good sources include the *Financial Times*, *The Economist* and more specialized journals such as *Euromoney* or *The Treasurer*. If you have access to an electronic or CD-ROM database look for articles since the date of writing of this unit (April 1993).

The topics were chosen for a number of reasons. First and foremost, they provide good chances to practise the skills of broad-scope analysis and decision-making that are the key learning objectives for this part of the unit. So far in this course you have considered topics that have often been quite broad or generic within their particular field but which have been ‘bounded’ in scope. Here we use a wide-angle lens and consider subjects that have implications for all fields of endeavour – but the very breadth of the view denies us the chance to ‘zoom in’ on specific features for detailed inspection. The necessary skill you will be honing is that of identifying the ‘local’ (micro) effects of ‘large-scale’ (macro) causes, and of designing appropriate responses to forces over which most of us mere mortals have little individual control.

Secondly, the topics were selected because they represent – to an extent – the ends of a time-scale. Going ahead with EMU, or not, will affect us all within the next few years, and we must plan now for the near-term implications. The demographic crunch is predictable but will not be upon us until the second quarter of the next century. However, if we do not put workable solutions into place within the next few years the problem is likely to be much more disruptive when society is forced to address it. By practising on these two cases you will be gaining experience which should make you better able to contend with analogous types of problems in your own future career.

Thirdly, we had to choose cases that are not likely to lose relevance over the life-span of this course. Pension provision and demography is clearly sufficiently ‘long-lived’; whether EMU is so, too, only time will tell – although it can certainly be said that whichever path Europe takes, it will have significant results for the constituent economies. Thus the repercussions should ensure that the topic continues to have relevance.

Lastly, we hope that you will find the cases stimulating and interesting to work through and consider in their own right.

It should be stressed that this unit deals with subjects that are ‘macro’ and ‘economic’ in their scope and nature, but it is not a unit on ‘macro-economics’. Throughout you should be thinking about the impact on performance – be it that of your own organization or of society – of the events under scrutiny.
2 Measuring financial performance

2.1 Introduction

In your earlier studies of accounting you will have met ratio analysis and used it as a good tool for investigating some aspects of an organization's performance, as measured in financial terms. Strictly speaking, the quantitative ratio calculations transformed the accounting data into useful information which was then taken as the starting point for a qualitative analysis of the subject under scrutiny.

At that earlier stage of study most people will have restricted themselves to working with the key ratios suggested by the text. Following this unit's theme of expanding the scope of discussion from the specific to the more general, this section goes further and considers two aspects that were previously taken for granted (to an extent): the stability of some of the elements used to calculate ratios, and choosing or creating financial measures appropriate to the particular organization.

What is meant by 'stability' in the context of ratio analysis elements? It is that where, for example, the ROCE for Companies A and B has been calculated, the two results are comparable because the elements used for both calculations have been derived on a similar basis. ROCE uses Profit Before Interest and Tax ('PBIT') and Capital Employed. If either or both of these differ markedly in how they have been derived for the two companies, the comparison of the two ROCE measurements will be misleading, even where the companies are otherwise suitable candidates for contrasting. Very few, if any, financial performance measures are meaningful on an absolute basis, so it is important that relative comparisons are valid.

When considering the challenge of varying derivation methods for accounting numbers there are two 'dimensions' to the situation: variation within a particular country's code and variation between the accounting practices of different countries. Of especial interest here are the differences between European Union (EU) [formerly European Community (EC)] members and the efforts to 'harmonize' procedures. The first part of this section will not 'solve' the problem but, by giving some information about the key differences between EU members' practices, it should help you to make allowances for them if you become involved in any form of intra-EU comparisons. Regarding variation due to applying flexibility within the UK's specific accounting code, an in-depth analysis is beyond the scope of this course and the point will be made through a few select examples. An optional activity at the end of Section 2.3 will suggest a path for those who wish to study the topic further.

Although most of the material in this section refers to private sector accounting (and concomitant measures), since it deals with the core principles, much of it has direct analogues in the financial measurement of public or not-for-profit organizations. All sectors have the same need to measure their activities using money as the unit, and have similar problems with doing so in an appropriate, accurate, timely and cost-effective manner.

The second half of this section will be shorter in terms of material but will require more from you in the way of activities. Since it concerns designing and applying performance indicators that are germane to individual organizations – your
organization in particular - this unit will do little more than suggest some guidelines and give a few pertinent examples of measures that are useful and meaningful but only in their own context, with one or two cautionary tales of indicators that were at best not helpful.

### 2.2 Ratio analysis – a further look

There is something of a natural tendency to associate precision of numbers with accuracy, and nowhere is this seen to better effect than in financial accounting. As a generalization, financial accounting is to do with figures used for external reporting and management accounting produces information for internal consumption within an organization. Of course, there is considerable overlap and also commonality of raw data. In financial accounts, assets are given precise values calculated to the penny, centime, pfennig or cent, but the number given may maintain little relationship to the true value of the asset it purports to represent. The accounting model used has great precision but, because it gives little information about the true state of the world, it can hardly be described as accurate.

A fictional but common example may illustrate the difference between precision and accuracy in financial accounts. *Pater’s Military Purveyors, Providers of Military Goods to the Home Guard*, shows in its annual accounts a fixed asset category:

- **Land and Buildings**: £2,654.64

In fact the asset referred to is the company’s shop and warehouse, bought in 1915 for £2,654 12s 9d - and situated just off Piccadilly in the heart of London’s West End. The accounts show precisely the amount paid for the property - but give little indication of the millions of pounds that the site is worth today.

The example above may be seen as a rather extreme example of a hidden asset but the principle is very important - it fuels such diverse topics as companies bought primarily for the excess value of their pension funds and the debate about including brand values on the balance sheet. Producing an acceptable and uniform practice for the latter is one of the most important challenges facing the accounting profession in the first half of the 1990s, both within particular countries and across the European Union as a whole.

In fact, as you will read shortly, it is only from a UK perspective that maintaining the historic value in the accounts looks ‘odd’. Indeed, for most EU countries revaluing fixed assets such as property would be regarded as decidedly out of the ordinary - and therefore possibly suspect.

#### Activity 3

In general terms, what implications will the low asset value for property have for measuring the financial performance of Pater’s Military Purveyors?

**Comment**

By dramatically understating the actual value of a major asset used by the business some indicators will be flattered and some penalized. For example, the capital employed will be reported much lower than the true figure, so the ROCE will be grossly exaggerated.
Vice versa, the extra value owned by the shareholders is not shown, making the gearing look much higher than it actually is. Either the business looks precarious when it is not or it could improve shareholders' return by borrowing more and investing in the business.

How can such discrepancies come about, and why are they permitted to persist? Should not the accounting standards be tightened significantly to prevent this 'abuse'? On balance, probably not. There are three main factors underlying the present system that contribute to the difficulties:

- Figures from a mathematical model produced for one purpose being used for others.
- The relevant standards must be applied uniformly to an extremely varied range of organizations, varied in terms of activity and/or size.
- Accounting standards are based on a particular business and social culture, and the results must be seen within the appropriate context. In particular, whether or not the reported figures are used as the basis for taxation can lead to dramatic differences.

The second point is the real key to why it is probably better to live with the present standards – subject to continuing evolution and development – rather than engage in a wholesale revision of the accounting system. If the prescriptions were hard-edged and rigid, a set of rules would be needed to cover each and every eventuality – very roughly, one set per industry for each category of large, medium and small organization. The benefit of the present flexible standards is that the number of rules is kept manageable; the cost is constant vigilance and caution when using the final outputs (Box 1).

The first point draws attention to the sometimes ignored fact that the audited accounts of a company are, at core, a public announcement of a private report from management to its employer – the body of shareholders – about what the former has done with the assets entrusted to it. While this is slowly being modified to acknowledge the needs for, and right to, information of other stakeholders, it is still the basic legal requirement, under UK law at least. In countries where the reported profit is used for assessing the tax charge – Germany and France, for example – the rules for calculation are strongly influenced by this fact, but the report is still in theory prepared for the organization's owners.

**Box 1 An example of necessary flexibility: FIFO versus LIFO**

The two commonest methods of stock valuation are **First In – First Out (FIFO)** and **Last In – First Out (LIFO)**. Given that the former is much more common, why should we keep the second available, making for a complicated rule?

First, does it make a difference? The answer is yes, particularly in inflationary times. FIFO will 'charge' the Profit and Loss (P&L) account with the lowest inventory cost when a sale is made, LIFO with the highest – assuring that new stock purchases cost the same or more than earlier purchases (normally a reasonable assumption). Most manufacturers, wholesalers and retailers ship the oldest stock first, so FIFO is usually a reasonable representation of how the business operates.

But not all industries work in this way. In particular, mining and power-generating companies tend to ship or use the *most recent* stock. This can be illustrated by how a coal-fired power station operates. The coal arrives from the mine (or dock if imported) and is dumped on top of the existing pile. The power station's loading crane or bulldozer then feeds the boiler, also from the top of the heap – so the *most recent stock is, in fact, burned first*. LIFO is the right model to use.
A simplified example should help to show how financial figures can – quite legitimately – be presented differently depending on for whom they are intended. Here the only alteration will be the date the company chooses to use as its year-end.

**Case Study**

Pete’s Trains Limited is a small toy company. As an approximation, it manufactures steadily from January through to September then sells all its stock (hopefully) over the Christmas period. It turns over £1,000,000 a year making a net profit of £100,000. Its stocks are at maximum around 30 September, debtors around 31 December and cash at 31 January. The simplified balance sheet is shown as at these dates, together with a few calculated ratios in Table 1.

If the Annual Report was produced for creditors or other providers of short-term funds, the optimum date to choose would be 31 January. This date shows the best liquidity ratios and greatest equity protection for debt: these are the measures most likely to reassure providers of short-term financing. On the other hand,

**Table 1  Pete’s Trains Limited – Balance sheet 19XX**

<table>
<thead>
<tr>
<th></th>
<th>30 September £000</th>
<th>31 December £000</th>
<th>31 January £000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>0</td>
<td>0</td>
<td>400</td>
</tr>
<tr>
<td>Debtors</td>
<td>0</td>
<td>1100</td>
<td>0</td>
</tr>
<tr>
<td>Stock</td>
<td>1000</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td>1000</td>
<td>1100</td>
<td>500</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>1500</strong></td>
<td><strong>1600</strong></td>
<td><strong>1000</strong></td>
</tr>
<tr>
<td>Creditors</td>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Overdraft</td>
<td>700</td>
<td>700</td>
<td>0</td>
</tr>
<tr>
<td><strong>Current Liabilities</strong></td>
<td>700</td>
<td>700</td>
<td>100</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>300</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Reserves</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>P&amp;L account</td>
<td>0</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>1500</strong></td>
<td><strong>1600</strong></td>
<td><strong>1000</strong></td>
</tr>
<tr>
<td><strong>Ratios:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>1.43:1</td>
<td>1.57:1</td>
<td>4.00:1</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0</td>
<td>1.57:1</td>
<td>4.00:1</td>
</tr>
<tr>
<td>ROCE</td>
<td>0</td>
<td>11.1%</td>
<td>11.1%</td>
</tr>
<tr>
<td>Current Fixed Assets</td>
<td>2:1</td>
<td>2.2:1</td>
<td>1:1</td>
</tr>
<tr>
<td>Total debt: Equity</td>
<td>2:1</td>
<td>1.67:1</td>
<td>1:1.5</td>
</tr>
</tbody>
</table>
31 December shows an equal ROCE and shows the company at its most substantial; since profitability and size are what usually impress owners, Pete's Trains would probably choose a 31 December year-end, and the other figures would never be made public. Granted, this is a somewhat simplistic case, but the results made public have been varied by the simple expedient of choosing the reporting date. A great deal more optimization for shareholders can be achieved by using the accounting rules' flexibility. This aiming of the figures at one set of stakeholders can make them less useful for other interested parties.

Note that the figures for a particular company can safely be compared year-on-year because, while the organization can choose (within limits) its accounting policies, once the choice has been made, it must be kept to even if it turns out to be suboptimum in what it portrays. Management cannot pick and choose on an arbitrary and annual basis, and it is this constraint that persuades them — usually — to pick a system that should prove fair and representative over the long term.

2.3 The European dimension

Much of the accounting system of any country will tend to look strange if it is not considered within the socio-political and business culture and history — especially the latter — that promulgated it. For example, the Department of Trade and Industry oversees the accounting profession in the UK; in Germany the equivalent rules are administered by the Department of Justice. In the UK auditing is seen as a business matter; in Germany as a legal one.

History can also provide insights. At their cores, the German and French structures look similar. This can be understood by considering their history. The following is a necessarily broad-brush explanation that would be deemed too simplistic by an economic historian, but it is essentially accurate. During the Occupation of France in the Second World War, the Germans introduced a version of their business code. In 1945 the French, not unnaturally, rejected most things introduced by the Nazi regime, but they saw that there was sense to the business code, so they allowed much of it to remain in their Plan Comptable.

In fact, this was not as magnanimous as it might appear. The Germans' code was based on that introduced into their country by a French visitor some years earlier — Napoleon. Oddly, Germany had maintained in their business law a purer form of the Napoleonic Code than had the French!

Given such history and events, it is perhaps not strange that the business codes of France and Germany (and other nearby countries) are much closer to each other than to those of the UK or Ireland. Indeed, it is possible to use a 'similarity scale' with Germany at one end and the UK at the other, and then to plot all the other EU countries' codes along the line. The divergence conflicts with the EU's goal of greater harmonization across the member states, in business reporting as in many other areas.

To this end the European Commission has instigated two Directives — the Fourth and Seventh — that should by now be incorporated into all member states' national laws. In practice, full implementation is taking longer than planned because it is a more complex task than was really allowed for. In the following activity you will read about some of the reasons underlying the difficulties.
Activity 4

Read sections 2 and 3 of the article by Simmonds and Azières, 'Accounting for Europe – success by 2000 AD?', in the Reader.

You are not expected to remember the technical details in section 3 but you should think through the implications of the various points raised for the accounts (and therefore the financial performance measures). A good way of so doing is to picture what would happen to the figures of your own company or department if it was governed by the different rules described, and then to think whether this would affect your managerial decisions and actions.

This is a substantial activity that will probably take you at least an hour.

Simmonds and Azières' (S&A's) research was done in 1989 but the main points raised still hold at the time of writing, although further progress has, naturally, been made. When (and if) full harmonization is achieved within Europe, be it based on common or separate tax and accounting systems, it will still be necessary to understand the topics described. This is because the different basis systems will continue to be represented by two key economic participants: North America and Japan.

You have read the main descriptive part of S&A's work; they also conducted a practical survey to see what the result would be of actually applying the codes of seven EU states to a common set of accounts. They gave the details of a series of transactions to accountants in Germany, the Netherlands, France, Italy, Spain, Belgium and the UK and asked them to produce balance sheets and P&L accounts under their country's code. Each team produced a maximum, minimum and most likely figure for net profit, and estimated both tangible and intangible assets for the balance sheet.

The key results are summarized in Tables 2 and 3 and Figures 1 and 2.

Table 2 Profit calculations

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(Source: Simmonds and Azières, 1989, p. 36)

Table 3 Return on net assets

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(Source: Simmonds and Azières, 1989, p. 42)
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Figure 1 Profit calculations – graphical representation of Table 2

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Figure 2 Return on net assets – graphical representation of Table 3
Remembering that all the results were created from the same raw data, representing a European multinational, it is indicative of the challenge to note that the minimum profit figures for Italy and the UK are higher than the maximum equivalents under the German, French and Dutch systems. The differences for total fixed assets are less pronounced but still significant, there being about a 25% variation between the lowest (German) and highest (Belgian) figures. Overall, the return on equity (or investment, or net assets) ranges from a low of 18.2% in Spain to a high of 27.0% in the UK.

ROE is a much-used performance measure, but it would have told us little here without some knowledge of the accounting system under which the figures used in the measure’s calculation were prepared. While the exact results obtained are only true for the particular company in question, the relative impact of accounting differences would be similar for many European organizations. Thus, should you need to make a cross-border comparison, the conclusions from this exercise could be used as a crude ‘first pass’ at ‘correcting’ foreign data into figures that are more comparable to your ‘home’ system. It would be very rough, but even realizing that Belgian profits are likely to be ‘understated’ from a British point of view (or vice versa for a Belgian business looking at a UK profit figure) would be an advance for many managers.

**Activity 5 – Optional**

If you want more detail of S&A’s results and methodology, read section 4 of the article.

**Activity 6**

Read the short conclusion to S&A’s article.

What conclusions should be drawn from this section’s discussion of the stability of accounting numbers? The intent is not to persuade you that the financial measures derived from such numbers are meaningless or – worse – misleading, but that you should have developed a better ‘feel’ for the limitations of the technique. To use a forestry metaphor, in earlier accounting studies you learnt how to read some of the health signs of individual trees; here the shape and structure of the wood has been surveyed. Understanding both is necessary to make a fair assessment of the productivity of the forest.

**Activity 7 – Optional**

If you are interested in investigating further the effects on the accounts and measures of the UK accounting standard’s flexibility, obtain a copy of *Accounting for Growth* by Terry Smith. The full reference is at the end of this unit.

You are advised to read the book as a set of case studies or examples of what is possible rather than as a wholesale indictment of the system. While some of the examples are clearly questionable, others could be given a more benign interpretation than that implied by the book. As with any such study, the reader must apply his or her own critical faculties to the opinions expressed by the author.
2.4 Appropriate measures

Just as accounting itself is subdivided, roughly, into an external (financial) and internal (management) pair, so can performance measures useful for external comparison be distinguished those from intended primarily for internal information. Some of the cautionary notes to keep in mind when using the former were explored in the preceding sub-section. Here we will consider measures that would be apposite within the context of your specific situation.

An example may help to illuminate the difference.

Major (and minor) retailers are, of course, concerned ultimately with measures such as ROCE and ROE, but for immediate managerial purposes they tend to use more direct performance indicators.

Chain stores such as Marks and Spencer or British Home Stores will look at the Sales per Square Foot for individual stores and Sales Turnover for particular items. A supermarket will look at Sales per Shelf Foot (the amount of display space taken up by the relevant item) as a key performance indicator.

Richer Sounds - a British hi-fi store - makes much in its catalogue of the fact that it is in the Guinness Book of Records as the ‘World’s Busiest Retailer’, measured in terms of Sales per Unit Area. It is sandwiched between the somewhat larger entities General Motors and AT&T. GM is there as the company with the absolute measure of ‘Largest Sales’ (1991: $123.8 billion); Richer Sounds with the relative top performance of the ‘Busiest’ with £17,553 per Square Foot (year end 31 January 1992).

In your previous management accounting studies you will have considered other financial numbers and systems which can provide internal performance measures; for example, contributions per unit and budget variances. Note that it is not the company or departmental budget itself that is a financial indicator but the measurement of difference between planned and actual output. These are generic measures that can be applied to most situations, but are there any guidelines that can be used to choose organization-specific indicators, such as the retailer’s Sales per Unit Area?

In most instances, appropriate ‘tactical’ measures can be designed and situated if they satisfy four key criteria (the RDCC Criteria):

- relevance
- directness
- clarity
- cost-effectiveness.

Relevance means the connection between the tactical measure under consideration and the strategic objectives of the organization, and the measures used for assessing achievement of those objectives. Using the examples above, measures of Sales per Unit Area can be shown to have a strong correlation with overall performance measured in terms of more traditional ‘macro’ measures such as ROCE, ROE or EPS (Earnings Per Share).

Directness refers the other way, to the connection with the specific product or process under scrutiny. Unless the picture of the situation given by a measure is clear and reasonably unambiguous it will not be helpful for managerial control and decision-making, and will ‘wither on the vine’ - justifiably so.
Clarity: a good financial measure must be readily understandable by all who need to use it. The importance of sales per unit shelf length is immediately apparent to all retailers dealing in items such as confectionery or packaged foods, and so this indicator satisfies the clarity criterion for this group of users.

Cost-effectiveness: it is very important that the cost of collection, calculation and interpretation in terms of all the resources absorbed is significantly outweighed by the benefits achieved from the increased information. This criterion also encompasses avoiding 'paralysis by analysis'.

These four hurdles can be used to test new measures, but also to look again at the existing set. A test sometimes run by information departments is to stop sending out particular reports, and then waiting to see whether anyone complains. All too often no-one does, implying that the information contained in the print-outs is no longer relevant. Note the term 'no longer'—many information requests were needed at the time of asking, but organizations move on and it is important that all forms of information, including performance measures, evolve similarly.

Activity 8

You can apply the users' version of the 'print-out test' to your own situation. Consider all the items of information which you gather or are sent regularly. What use do you make of each one? If none, why waste time (and trees) producing it? If it is something you use constantly, could the presentation or content be improved in any way?

As a cautionary note, it is worth looking at an example of an odd but appropriate indicator, followed by one of an inappropriate measure, and the consequences of using it. It is merely coincidence that the latter is a public sector case—examples of good and poor practice can be found in all sectors. Both are based on actual situations.

Sails and sales

The owner of an East Anglian sail-maker approached his bank for a small loan to fund a minor expansion. The bank manager rapidly became somewhat bemused because the business was clearly strong and well run but the proprietor could tell her little in detail about such standard measures as ROCE or ROS.

When asked what measure he actually used for assessing the prospects for the business, he replied 'Wins'. When asked to clarify this cryptic response the owner explained that each week he counted the number of wins in dinghy regattas by boats using his company's sails—in the context of the relevant market sector, a very appropriate indicator of future company performance as there was a very high correlation between race wins and future sales of sails.

(Adapted from Berry et al., 1993)

This measure certainly fulfils the relevance and cost-effectiveness criteria: it is also acceptable for directness within its specialized milieu. On the subject of clarity, it is definitely understandable to those within the business but less so for outsiders such as the bank manager. This is not a problem, provided measures are available that do make sense to other stakeholders for use in discussions with such interested parties.
Social work or bell ringing?

A Social Services department wanted to gather information on its own effectiveness in alleviating distress in its area. Among other initiatives, it decided to instigate a performance measure for its social workers.

The aim was to see how effective the group was at solving - or at least coping with - the major social problems in the area. Of course, measuring something as qualitative as 'reduction in distress' was not straightforward, and would probably be very complex and expensive to administer.

The department therefore settled on a proxy that was simple and cheap to implement: number of visits made per social worker. The logic was that there should be a reasonably strong link between calls made and provision of social services to the client population.

Unfortunately the system had a major flaw. Ringing the doorbell of a client's house or flat counted as a 'visit'. A social worker could therefore achieve a much better rating by 'visiting' many empty homes in the same length of time it would take to deal with a case where someone had the temerity to be at home when the doorbell rang.

The doorbell measure failed all four criteria. It was cheap but also ineffective, so cost-effectiveness fell. It had clarity - it was clear to all social workers that they were being induced into incorrect behaviour by the need to optimize the measure not the true performance. It was not direct - there was little congruence between measure and reality - and it was certainly not relevant, there being no connection between the quantitative measurement of bell rings and the qualitative goal of helping the under-privileged members of the community.

This example - the department concerned has since changed its practice - shows another important aspect of choosing indicators: a good measure can be encouraging but a bad one can have a dramatic negative effect on organization morale. Given that it takes much longer to restore esprit de corps than to destroy it, this consequence of a poor choice reinforces the need to be very careful about designing performance measures, financial or otherwise.

**Activity 9**

Counting 'visits' in the Social Services example was a poor measure of performance because it did not relate accurately to people helped. Could this problem be overcome by counting 'cases dealt with' instead?

**Comment**

While such a measure would probably have been an improvement, it would have had difficulties of its own. Looking at cases 'dealt with' immediately raises the question about what is meant by 'dealt with'. Case closed/solved? This could encourage the staff to concentrate on the simpler cases to the detriment of the complex ones. Hours spent with clients? But the department needed to know how effective was the social workers group, not how long was spent with people. The latter might or might not reflect the former - the correlation was one of the things the measure was supposed to indicate.

Activity 9 may have given some impression of the challenge facing any manager who tries to use relatively quantitative financial indicators for measuring very qualitative and possibly quite nebulous objectives. It is often difficult but seldom impossible, and the very action of designing a good measure can often improve a manager's understanding of his or her immediate situation.
Activity 10

(a) Subject the measures you and your colleagues use at present to the RDCC Criteria test. If any fail on one or more of the four, could a minor alteration to the measure rectify the problem?
(b) Applying the RDCC Criteria, design at least one new performance indicator for your department or organization. How would you implement it? Would it encounter resistance? If so, why?

In this discussion we have been mainly concerned with 'tactical' measures as they are usually more immediate and relevant to current managerial action, but we should not leave this topic without a brief return to a consideration of organization-wide strategic measures.

Activity 11

Skim through 'Measuring strategic performance' by Balaji Chakravarthy in the Reader. Concentrate more on the findings and conclusions than on the in-depth analysis.

You will be reading this article in greater detail as part of your Block 4 study, so treat this as a brief foretaste, and limit time spent accordingly.

One important point to note in connection with the Chakravarthy article concerns the need to consider risk as well as return when dealing with the output of strategic performance measures. A significant criticism of the Peters and Waterman (P&W) work that started much of the debate is that, because it was an a posteriori investigation, it could not distinguish between a genuinely 'excellent' corporate strategy and one that was merely very high risk and lucky – at least until the date of the survey. Were there businesses that had followed similar 'excellent' strategies but did not show up because those very strategies had killed off the unlucky ones? Indeed, within a couple of years of publication of their book *In Pursuit of Excellence*, a statistically significant number of P&W's 'excellent' organizations had run into major problems – although it should also be noted that most coped well with their difficulties.

This is a more general conundrum than it might at first seem. A suite of strategic measures designed for an organization needs to indicate not only the absolute and/or relative performance but also the match between the planned and actual risk profile of that organization. This idea should gel with your studies of strategic management, and is considered further in Block 4 of this course.

2.5 Summary

In this section you have concentrated more on the difficulties of financial performance measurement than on its strengths. By this stage of your MBA studies, and from your own experience, you should have already appreciated the pervasiveness of financial measures, for good or ill. You should also be able to distinguish between indicators that are truly 'financial' in intent – ROE, for example – and those which are more general in intent but easiest to measure in monetary terms, such as Sales per Unit Area for retailing.
To make proper use of any form of measurement requires an understanding of not only what is measured, why it is done so and how to go about it but also the limitations of the numbers obtained. In many situations basing decisions on information outside its 'relevant range' (to use a term you should remember from break-even analysis in the prerequisite course) can be more dangerous than having no data at all with which to work. At least when one has no information one acts with due caution.

With this aim in mind, you have read quite extensively about the ‘vagueness’ of supposedly ‘hard-edged’ accounting data. By now you should be in a position to make better use of such figures because you are able to place them within their context – thereby stripping away much of the perceived vagueness. Through understanding more about different ways of counting and measuring financial numbers you will be better placed to transform such data into genuine and valuable information, useful to any practising manager.
3 European Monetary Union

The remainder of this unit is concerned with practising the analysis of macro-economic events or situations, with the aim of identifying 'local' effects of these large-scale forces. By their nature, these influences are not amenable to alteration by an individual organization, so one must be prepared to incorporate them into policy and activity as facts of life that will affect performance, for good or ill.

The following two case studies aim to help you get to grips with the process of such analysis; a suggested paradigm is included between the case studies (in Section 4), which you may find a helpful generic framework for future macro-economic interpretation.

To start, a subject that will have very significant implications for all of Europe's businesses and people, be the decision to go ahead with or to turn away from European Monetary Union ('EMU').

3.1 History

A little historical economic context is necessary before considering the decisions that are to be made concerning EMU. Without some understanding of what has gone before – of what has been tried before – it is even more difficult to make sense of current choices or decisions.

The gold standard

Before the 1939–45 War the predominant economic policy was that of the gold standard, where countries fixed the value of their currencies against gold – and thus against each other – and maintained the parity rate. Citizens were entitled to receive physical gold on surrender of their bank-notes (the origin of the term 'I promise to pay the bearer on demand the sum of...' printed on all UK bank-notes). Thus governments could not 'print money' much in excess of their reserves of gold. If a government tried to inflate its money supply to the extent that people lost confidence in the currency it risked a major run on its reserves as people demanded the reassurance of physical gold. Note that there is nothing unique about gold in this context. It could have been any commodity that was reasonably scarce and that was perceived to have value. Throughout history, gold has maintained those attributes, but other items could have been used. In parts of Africa and Southern Asia perfectly workable currencies existed based on cowry shells, which were rare and valued in the relevant areas. Indeed, there is a species called Cypraea moneta – the money cowry.

The key to the gold standard was that it had – in theory – an in-built mechanism that prevented governments from indulging in inflationary 'binges' – money could only be created as fast as gold could be accumulated. It did, however, have several disadvantages. One was that it was rather peculiar to measure, in effect, the value of a country (via the medium of its currency) solely in terms of the amount of a particular yellow metal it locked away in bank vaults, rather than in terms of its physical and human assets, and their productivity. More importantly in the context of EMU, the systems of adjustment that did not include flexibility
over exchange rates were prone to producing long and deep recessions in individual countries. It was not that the gold standard *caused* recession, simply that the tools available for ameliorating such down-turns were inherently slow-working. On the other hand, proponents of the system would probably argue that the remedies were slow but long lasting and effective, which in itself would tend to reduce the risk of future problems.

**Bretton Woods**

The UK was on the gold standard from the end of the Napoleonic Wars until 1931 (with a suspension from 1914 to 1918). Other major economies joined in throughout the nineteenth century, and the principle lasted until the Second World War.

One of the major conferences held when the end of conflict was in sight concerned what was to be put in place as the new world financial system. The conference was held in July 1944 in New Hampshire, USA at a place called *Bretton Woods*, from which small town it took its name. The principal architects of the Bretton Woods agreement – which set up the World Bank and International Monetary Fund (IMF) as well as the exchange rate system – were Harry White for the Americans and John Maynard Keynes for the British.

**Activity 12**

What are the primary roles of the IMF and the World Bank?

**Comment**

The IMF is responsible for providing member governments with short-term resources for coping with temporary balance of payments problems. The World Bank takes on funding for long-term structural projects – its real name is the International Bank for Reconstruction and Development.

Regarding exchange rates, in essence the US dollar took over the role of gold (which was why the system became known as the *dollar standard*), all currencies being fixed against the ‘almighty dollar’ instead of against metal. The two key factors were that:

1. countries did not need to keep 100% dollar reserves backing their currencies and
2. while usually fixed, countries could occasionally negotiate to re- or devalue the parity rate.

The intent of this ‘safety valve’ was to permit a re-balancing of exchange rates when a major shock to the trading environment changed the situation significantly, for example the OPEC price increases of the 1970s. It was also there to counter where differential rates of inflation had caused a country to have competitive difficulties with foreign trade (see Box 2 overleaf). To put it crudely, the gold standard forced governments to squeeze out inflation even at the cost of unemployment and/or recession; the Bretton Woods system allowed for more flexibility in government policy, for example ‘trading off’ a little extra inflation against maintaining growth.
Box 2  Purchasing Power Parity

Assume that there are two countries, A and B. The currency of A is the groat, and a standard loaf of bread costs Grtl; that of B is the doubloon, and an identical loaf there costs Db2. In both countries it takes 20 minutes for the average person to earn a loaf. If the exchange rate at Time 0 is Grtl = Db2, then the ‘real’ value of the two currencies is the same – the same item (or group of items) costs the same in the two countries. Now assume that there is no inflation in A, and 10% inflation of wages and prices in B. At Time 7.25 years, the loaf should still cost Grtl in A but now Db4 in B; it still takes 20 minutes’ earnings to buy it in either country. If the exchange rate is still locked at Grtl = Db2, all the goods of A will be half the price in B of their domestic equivalent. A will have an export boom, and all B’s bakers – and butchers, candlestick makers and manufacturers – will be bankrupt and unemployed. To correct the predicament will require deflation in B, which usually means recession. In reality, the government of B would have been forced to act to reduce the inflation rate well before the situation went this far.

Alternatively, if the financial system permitted it, B could devalue its currency with respect to A to restore competitiveness.

If the groat/doubloon exchange rate was free to find its ‘natural’ level it would change to match the variation in prices in the two countries, so that the same amount of labour continued to earn the same ‘real’ reward. ‘In this example, the theory says that the exchange rate would stabilize at Grtl = Db4. The ability to buy remains in balance – Purchasing Power Parity (PPP).

Activity 13

From what you know about how exchange rates move in reality, can you think of a problem with the application of PPP in ‘performance measurement’ terms?

Comment

The theory assumes that the two currencies are ‘in balance’ at the start. But what point in time do you take as the baseline? When bread costs the same? French, German and British loaves are very different! When a Volkswagen costs the same? Car prices are set by what each market will allow, not a ‘fair’ Euro-price. Furthermore, floating exchange rates are affected – one might say buffeted – by many other economic and political factors, and so tend to be much more volatile than PPP would predict. It is not that the theory is wrong or useless, it is merely incomplete and so can be taken only as a rough guide.

For 25 years the world enjoyed sustained growth (on average). Whether that was because of, unconnected with or despite the dollar standard is still debated, but the consensus is usually that the system was effective for the economic conditions prevalent at the time.

However, the system did have flaws. Because changes in a country’s parity had to be by international consensus, and because it became a matter of political pride not to devalue, rates only changed by infrequent and quite large amounts, instead of more often and by small amounts. Only when forced to by a major crisis would a government in the 1950s or 1960s encompass a devaluation. To maintain the safety valve metaphor, the blow-off pressure was set too high, or the valve was ‘sticky’. If a country was having sustained problems with balance of payments, speculators had a ‘one-way bet’ – the ailing currency would certainly not revalue so they could sell it in the sure knowledge that, at worst, they could buy it back later at the same rate, and would probably make a handsome profit if a significant devaluation was forced upon the offending government.
A second difficulty was that the whole system was predicated on a strong and non-inflationary dollar. Referring back to the gold standard, the two main criteria for a store of value was general acceptability and reasonable rareness; at the time of the Vietnam War, America started running large deficits with the rest of the world. This had the effect of flooding the international system with excess reserves, which in turn led to a general increase in inflation. As stated earlier, this is not a text on macro-economics and the details of monetary theory are not needed here, but note that the system ran into trouble partly because of a potential inherent flaw (the practical problem with arranging realignments) and partly because the scenario for which it had been designed no longer held sway.

Before describing the 1970s' floating rate environment, a last word on White and Keynes' 'grand plan'. It is often said that the Bretton Woods Agreement 'collapsed in 1973'. In fact the exchange rate parities part alone disintegrated in 1973. The whole international financial system is still built upon the work done in New Hampshire in 1944.

**Floating exchange rates**

For many reasons, including those mentioned above, the system of fixed parities based on the US dollar became unsustainable by the early 1970s. In 1973 the major currencies were set free to 'float' to whatever exchange rate balanced supply and demand. At different times and in different countries the 'cleanliness' of the float varied. Sometimes governments used their fiscal and monetary powers to control the domestic economic situation, leaving the exchange rate to 'find its own level'; at other times the state has tried to use economic policy to maintain a preferred rate of exchange, or a 'comfort band'. Success has been varied, but it would be generally true to say that the markets have punished governments when they tried to bluff rather than to instigate policies that matched their rhetoric. A painful lesson learnt by many central bank and treasury officials since 1973 is that, while a central bank is infinitely more powerful than an individual or a single institution, the world financial market as a whole is stronger still – and is merciless if a rift between word and deed provides opportunities for profit.

On the other hand, the floating exchange rates were much more volatile than had been expected pre-1973. The swings were quite violent and destroyed much of the stability that had helped foster the increase in international trade. Forecasting a company's revenues became yet more difficult as exchange rates moved rapidly. Together with the very high and unpredictable inflation suffered by many developed countries, this made for great uncertainty – which in financial terms is a definition of risk.

Risk is only taken on where it is justified by potential reward. In the 1970s many investors suffered negative **real rates of return**. Not unreasonably, this caused a reduction in the supply of capital until the providers saw a very significant increase in the real rate of return. As inflation fell it was expected that these real risk premiums would also decline. However, the pain of the 1970s seems to have traumatized the world's savers. They are less confident about governments' ability to control inflation – so the historically very high real rates of return are still with us in the 1990s. As we shall see, reduction in risk - and therefore a reduction in the real cost of capital – is one of the main aims of EMU.

The wild fluctuations in exchange rates after 1973 persuaded most members of the EU to form in 1979 the European Monetary System (EMS). There had been an earlier version, known colloquially as the 'European snake', but that self-
 destructed in the wake of the oil crises. In this new Exchange Rate Mechanism (ERM) the members defined parities against each other and committed to maintain their rates within a band, typically ±2%. Realignments to take into account real divergences in inflation, for example, were to be allowed after consultation. In the early years such realignments were reasonably frequent but usually of small magnitude; in the latter half of the 1980s realignments became much less common, and the aims of the EMS shifted in practice from dampening down violent swings to something approaching a fixed parity environment.

Activity 14

Summarize briefly the key benefits and risks of a 'hard fixed' exchange rate system (such as the gold standard) and of a 'free float'.

Comment

Essentially, a fixed rate system forces governments to follow anti-inflationary policies. It also provides a stable and certain environment, which is important for business confidence and planning. On the down side, the lack of flexibility risks slowing recovery from recession by constraining governments' tools for management. Also such a system cannot cope with economic 'shocks' that produce genuine changes in the relative economic positions of countries.

A free float is almost the precise opposite. It flirts with the chance of extreme volatility in exchange rates, which can then cause a risk premium to be built in to the cost of capital demanded by savers. There is no structural restraint on governments resorting to the printing press, causing inflation. But freely floating rates did cope with the two 'oil shocks' of the 1970s, which would have blown apart any gold standard-type system if it had then been extant. Furthermore, in a democracy the electorate can choose a government that avows to be anti-inflationary, so there are restraints available other than the strait-jacket of an immutable exchange rate.

3.2 The implications of EMU

Note: The name of any future single European currency is not an unimportant part of the discussion but, for the purpose of this exercise in analysis, the relatively neutral term 'ecu' will be used throughout.

The difference between EMS and EMU

In many ways an EMS where the parities are meant to be immutable and a single European currency infer the same policy requirements for governments. In both there is no leeway for the two states to regain PPP after suffering from divergent inflation rates by re- or devaluing their currencies. Adjustment is by fiscal and monetary methods akin to those under a gold standard.

However, there is one crucial difference that stems from the rather obvious fact that the former retains the individual currencies whereas the latter does not. In a fixed rate system if the financial markets believe that the parities are not sustainable, they can speculate against them by buying the strong and selling the weak.
The size of the world markets means that so much pressure can be exerted that the unsustainability becomes a self-fulfilling prophecy, as happened under the Bretton Woods system and when sterling and the lira were forced out of the ERM in September 1992.

With a single currency, no such speculative pressure is possible as there is nothing with which to exert it. Difficulties caused by real divergence in competitiveness would still need to be corrected, but the artificially induced pressures of expectation would be alleviated.

A single currency would also entail a single ecu interest rate, which would depend on Europe's overall money supply. It would probably be close to the present ecu rate, which is a weighted average of the rates of the constituent currencies. So countries which typically in the past had low interest rates would probably find that their cost of capital increased somewhat, and high interest rate currencies would enjoy a reduction. Excluding the exceptional rates situation caused by German reunification, taking history as a guide, Germany, the Netherlands, Denmark, etc. would be losers and Spain, Portugal, Italy, the UK, Ireland, etc. would benefit.

An ecu rate would probably be more stable than that of most individual EU currencies as it would reflect monetary conditions of a much larger, diverse area. This would tend to reduce the impact of any one country's economy on the total picture.

**Sovereignty over monetary and fiscal policy**

The EMS does not require governments to give up their individual currencies, and so they maintain control over their own interest rates, money supply and acceptable level of inflation. EMU, on the other hand, implies a single European Central Bank (ECB). Such an institution would probably have the present national central banks as 'branches' – much as the US Federal Reserve consists of 12 regional Banks and the Bundesbank system is represented in each of the Länder – but would be responsible for maintaining monetary policy on a European-wide basis. Accountability would be to an EU body, not to individual national governments. The 'prime directive' of such a Bank would be price stability for the Union as a whole, much as the Bundesbank is obligated to strive towards for Germany by its Federal Republic charter.

Interest rates and money supply growth would be administered by the EU body, not by national parliaments. In other words, control of monetary policy would have been ceded to this supra-national, EU-level organization.

**Activity 15**

The ECB described above would definitely be a theoretical reduction in national sovereignty over monetary policy. Would it be a practical reduction in such control for countries committed to maintaining their ERM parities?

**Comment**

No – in practice, to maintain an ERM parity a country must not allow inflation to diverge significantly from that of the member nation perceived to have the best anti-inflation record. This usually means Germany, where history demonstrates the independence and single-mindedness of the Bundesbank, and its long-term
success in dampening down inflation. Thus interest rate policy for all ERM members is driven by that of the Bundesbank.

Indeed, it could well be argued that an ECB would give the other ERM states more say in monetary policy. An ECB would be mandated to set monetary policy taking into account conditions across the whole single-currency area. The statutes of the Bundesbank only permit it to consider the situation in Germany. So ERM means that effective monetary policy for all member countries is set by the circumstances peculiar to Germany alone.

So EMU would – for good or ill – transfer control of monetary policy from individual states to the ECB. But what about fiscal policy? Would governments keep control over that?

Although some proponents of monetary union who also favour a politically united Europe may argue otherwise, nothing in EMU demands that governments also cede fiscal sovereignty. It is true that they would be constrained from printing money to fund budgetary deficits, but they would not be barred from deficit financing that they could support by raising funds on the international capital markets. Or, to put it more crudely, they could borrow as long as their ‘credit was good’ but could not ‘inflate away’ national debt. Since all present and recent European governments have disavowed resorting to the printing press such constraint does not further reduce their room to set fiscal policy.

Activity 16

Think about the record of governments of your country over the last 10 years with respect to inflation, and monetary and fiscal policy. Decide whether, in your opinion, the economy would have performed better, worse or no differently over this period if you had been part of a single EU currency block.

3.3 The pros and cons of EMU

In this section we will consider some of the reasons for and against a single currency. The analyses are intended to be objective but, as the main sources were pro-EMU, unintentional bias could have been included. You will be asked to assess the evidence for yourself, and to consider how such matters would impinge on the performance of your organization.

To redress any residual bias, Section 3.4 consists solely of an article that is against EMU.

Transaction costs

It has been estimated – quite carefully – that a single European currency would save about 0.4% of the Union’s GDP by eliminating the intra-European currency exchanges presently required by trade, investment transfers and personal transactions (Emerson and Huhne, 1991).

Activity 17

Does 0.4% of GDP represent a gain important enough to warrant the move to a single currency?
Comment
While 0.4% may not sound a great deal, it is an annual gain, not a one-off benefit. In terms of GDP growth, 0.4% per annum could well be seen as significant. In money terms it represents about ecu 20 billion a year (about $15 billion).

Activity 18
Would you expect all member nations to benefit roughly equally from a European currency?

Comment
Probably not—small countries where trade denominated in other EU currencies represents a larger than average proportion of GDP should benefit more. In fact the estimates are that the larger economies, such as Germany, France and the UK, may only benefit by 0.1–0.2% of GDP; vice versa, the Benelux countries—for example—could gain as much as 0.9% of their GDP.

Activity 19
Will the 0.4% of GDP be a pure gain?

Comment
No—much of the foreign exchange dealing costs incurred are paid by European companies to European banks. So a single currency will improve the position of industry—but at the expense of the banks, to an extent. It is a transfer of benefit rather than an overall gain.

However, it is also quite probable that the improved condition of their industrial customers will allow the banks to recoup their reduction in income by the increase of activity in other areas.

So the economic gains of removing transaction costs is an important factor, but it is not clear just how large the net benefits would be.

Are there any costs implicit in the ‘mechanics’ of moving to a single currency? Would such costs be continuing or ‘one-off’ conversion penalties?

Activity 20
Consider what would need to happen if your country shifted from its domestic currency to a pan-European one. Here we are concerned with the practical, physical changes that would take place rather than the economic and political policy alterations. Include differences of both a personal and a business nature.

Comment
A non-exhaustive set of possibilities is included in the following text.

A very obvious change would be the need to replace all the notes and coins with new ones. Note that, since most money these days is in the form of electronic records (bank accounts, etc.), the actual conversion of the bulk of the money supply would be easy to achieve—simply apply one last exchange rate to change the balances into ecus.
While the percentage of total outstanding money supply represented by physical notes and coins may be low, it cannot be ignored. The UK's conversion to decimal currency in 1973 and the East German Ostmark exchange for Deutschmarks in 1990 are the closest analogies on which the EU can draw.

Notes are quite short-lived, so the incremental expense of reprinting would not be excessive, but coins are rather different. New minting of coinage to a common European size, weight and value could prove to be a significant one-off cost.

More importantly, it would then require all of Europe's coin machines to be modified to take the new money - a huge and costly undertaking - although the argument about banks and companies over transaction costs applies here, too. Much of the expenditure would be incurred by European companies with other European companies; nevertheless, it still represents use of productive capacity that would otherwise be available for creating goods and services, and thus is a true economic cost.

Activity 21

One suggestion is that some of the old coins could be kept on, simply representing an ecu amount instead, e.g. a £1, FFr1 or DM1 coin would become an Ecu1 coin. Is that a practical suggestion?

Comment

It seems fraught with difficulties. If all three coins mentioned above became equal to one ecu, all franc and Deutschmark coins would be hoarded before conversion day (because they would then suddenly gain significantly in value). Vice versa, no-one would want to use pound sterling coins because they would be devalued. In theory, it could work if all coins were 'rounded down' in value. People would then hold the least coinage possible just before conversion (thus minimizing losses, as all bank accounts, etc. would convert at a fair rate), enabling the same coins to be reissued on 'E-Day' at their new ecu value.

On the other hand, the political 'flak' might be too great. All citizens holding coins would lose something, and very probably the press would have a field day by finding somebody who 'didn't understand and have all my life savings in &/DM/FFr coins'. More importantly, we would have a single currency - but British coins still would not fit a Paris Metro machine.

Overall, it would probably be better to accept the upheaval and re-mint euro-standard coinage from the start.

As for coins and notes, so too for postage stamps and so on, although that should not be so complex. Already the UK Post Office has issued stamps that have '1st class' or '2nd class' on them rather than a monetary amount; such a system would obviate the need to alter the bulk of stamps. Those used for non-standard amounts could easily have both a domestic and an ecu value printed on them long in advance. Note that we cannot deal so easily with the bank-notes and coins discussed above because, to be useful, they must represent a meaningful proportion of an ecu - an Ecu0.814 coin is not likely to be welcome!

The idea of 'dual value' could also help with the other very major item that would need to be dealt with: contractual values. Provided sufficient notice was given - some contracts are very long-lived - organizations should not have too much difficulty in avoiding later dispute by writing both the 'old' domestic currency value and the 'new' ecu amount into their agreements.
Probably the most difficult – and therefore the most expensive – problem would be educating everyone to operate in the new currency. No serious estimation has yet been made on this point. Being optimistic, there is evidence that people manage, on the whole, to cope with foreign currencies when they go abroad, and that the UK’s decimalization succeeded without too much public anguish. On the other hand, nobody has persuaded the British or Irish to stop using and thinking in terms of pints, gallons, pounds (weight), miles, feet or inches. Perhaps at this stage all one can do is note the need and to plan for public education before the event.

Note also that this investment in education is vital to ensure that the intended gains in economic performance are not dissipated by confusion and general dissatisfaction. As always, care is needed to identify and take into account individual human factors even when dealing with such ‘macro’ subjects as EMU.

A final cash-management benefit for organizations that have frequent dealings in numerous European currencies would be that they could probably reduce the total cash ‘float’ they need to maintain. At present such businesses have to keep a working balance in all their different currencies’ accounts – holding everything in ecus could significantly reduce the need for such ‘idle’ cash balances.

**Activity 22**

Think about your own organization.

- What changes would be needed to convert to a single European currency?
- How would the change affect your operations?
- What would be the costs involved?
- What would be the savings?
- Would it be worth it for your situation?

**Risk reduction**

In the preceding sub-section we looked at the ‘direct’ costs and benefits of the EU having one currency. There is another very important benefit for businesses; one that is harder to estimate with any certainty but which may well be greater in the long run than the benefits of transaction expense reduction.

By removing the chance for the value of an intra-EU contract to vary in terms of the currency of one or both parties to the agreement, a very important item of concern – exchange risk – would be eliminated entirely from all trade within the single currency area.

It has been argued that this is not very relevant nowadays because there are many clever financial instruments that can be used to negate such risks. While this may be true for large organizations with specialized and highly trained treasury departments able to make use of such products, it is very debatable whether the average small to medium enterprise in Europe has access or the expertise to avail itself of such solutions. Moreover, such systems are by no means costless, in terms either of direct transaction expenses or of necessary infrastructure to handle them. Many of the products are, in any event, designed to deal with the exchange risks from day-to-day business operations (transaction exposure) and are not well suited to eliminating long-term risks such as owning foreign factories (translation exposure).
Activity 23

Consider the operations, assets and liabilities of your own organization. They are, probably, exposed to some exchange risk. Transaction risk measures fluctuations in value of items moving through the organization, such as purchases and sales of goods; translation risk is concerned with changes, in terms of the accounting currency, in the value of long-lived assets (and liabilities) actually measured in another currency – for example an overseas factory. What, roughly, is the transaction and translation exposure to which your organization is subject? How much impact on the profit or surplus could this risk have? Alternatively, how much does it cost to eliminate the risk?

Many organizations think that they are not exposed to exchange risk because they operate on a purely domestic basis. This is a potentially dangerous fallacy. Such enterprises are very often still at risk because of economic exposure. Two examples should serve to demonstrate the risk. First, a UK manufacturer of electric hand tools for the building trade buys all its components, performs all its production processes and sells exclusively in the UK – but its three main competitors are German, French and Italian. In terms of market price and market share, the UK manufacturer is seriously affected by the £/DM, £/FFr and £/LIT exchange rates – and in a way inherently incapable of amelioration by the methods mentioned in the preceding paragraph. A single currency would, of course, not alter (directly) the underlying competitive position of the four manufacturers, but it would remove the vagaries in apparent efficiency caused by exchange rate fluctuations.

Second, consider the effect on the local authority in Cherbourg of the devaluation of sterling after its withdrawal from the ERM in September 1992. The local Normandy fishermen were undercut by competition from the Channel Islands. If a significant number were driven into unemployment the Cherbourg economy would not only have lost tax revenue but at the same time needed to provide an increased level of services. Note that the fishermen competed effectively (and on friendly terms) with their Jersey and Guernsey fellows until the change in exchange rate, which had nothing to do with the relative efficiencies of the Normandy and Channel Island fishing industries.

The effect of the removal of intra-European exchange risk has wider implications. The cost of capital is directly influenced by the perceived risk. If the risk is reduced it can be expected to reduce the cost of capital over time, which would boost investment and output. The magnitude of the gain is very difficult to assess but one estimate – admittedly produced for (not by) the pro-EMU European Commission – put it on the order of 5–10% of Union GDP, taken over time.

This reduction in the cost of capital is not the same as the fall to the average rate of the high-rate currencies described earlier. It is a genuine, Europe-wide reduction in the risk premium over inflation demanded by the providers of capital – a genuine gain to the users that is not ‘unfair’ to the suppliers.

A final, ‘macro’ point about the removal of exchange risk. Europe as a whole would not need such large foreign currency reserves. The countries would still need reserves for normal trade purposes, and the ecu would still need reserves for management against, for example, the dollar and the yen. But the amounts needed for maintenance between European currencies would be surplus to need, and the governments of Europe could reuse the excess.
Activity 24

Summarize the arguments and points put forward so far, and access their validity and importance. From your research asked for in Activity 2, include any other points that your collection of articles post-April 1993 bring out, or that alter the arguments put forward here. Decide whether you feel the pendulum swings towards or away from EMU for your country – and how vigorously.

3.4 The case against EMU

The article on pp. 32–35 is reprinted from The Economist, 13 June 1992. Professor Feldstein is a pre-eminent economist with an admirable reputation. Nevertheless, in this article he is trying to win an argument, so may not have been as impartial in presenting his case as he would have if writing a paper for publication in an academic journal. The Economist is a declared ‘pro-EMU’ newspaper, and Professor Feldstein had the clear brief to put the case for the opposition.

It is thus reasonable to ask you to question whether the points made stand up to scrutiny, and whether they make a convincing case against monetary union for Europe. After reading and critiquing the article you will be asked to add the factors brought out in your analysis in Activity 24 and then to decide whether it alters your conclusions. Read the article now.

Activity 25

Summarize the arguments put forward by Professor Feldstein. Are they all sound? Rank them in order of importance, and add them to your earlier list from Activity 24. Do they alter your conclusions?

While much of Professor Feldstein's article is difficult to contradict, some of his points are a little disingenuous. Others stated as facts are closer to interpretations from one view of economics.

An example of the former: he points out that a British manufacturer exporting to France would be at a disadvantage compared to American producers if the US$ depreciated against the FFr and the £/FFr rate remained unchanged. True – but equally likely, the dollar could appreciate against the franc. In that case a floating pound might well follow the dollar upwards whereas a fixed exchange rate would enhance the UK competitiveness compared to US goods. Picking special cases with no economic rationale for so doing does not make for a plausible argument.

In similar vein, when discussing the pros and cons of a European Central Bank, Professor Feldstein says '... it implies a potentially very large sacrifice of potentially good monetary policy.' Why? Why assume that the ECB would not make equally good monetary policy given the same situations? If anything, economic history shows a clear correlation between the independence of a central bank and the maintenance of sound monetary policy on a long-term basis. The ECB would be charged with applying policy appropriate to the whole ecu zone, and is thus inherently less subject to political manipulation by a single member nation than would be its own central bank.
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Professor Feldstein asserts the need to keep the opportunities for individual parliaments to follow their own monetary and exchange rate policy, but then praises the success of the present EMS as an anti-inflation vehicle, which depends on all the members following the stance of the Bundesbank. The dangers of Europe-wide monetary policy being set by domestic pressures of just one key member was made all too apparent to Germany’s partners in 1992/3.

### 3.5 Summary

Much of Professor Feldstein’s argument shows that one should support either freely floating exchange rates or a single currency, depending on one’s interpretation of the economics and the trust one has in national politicians, but that one should not favour a rigid fixed-parity system such as that into which the ERM evolved in the late 1980s. A stance with which I—who on balance favour a single currency—would agree.

But the important opinion is yours, together with the logic that produces that conclusion. The aim of going through this case was to give you practice in analysing situations that are huge in scope and scale but which, nevertheless, have direct import for the performance of our organizations, now and in the future.

With such matters there are seldom simple answers—or any answers at all—but we must devise strategies to optimize the outcome for us, notwithstanding the difficulties. Planning, forethought and positioning can dramatically improve our performance when the effects of ‘macro’ decisions filter down to organizational level.
4 A *modus operandi* for 'macro' topics

This unit began by stating that it would not be a tract on economic theory but about dealing with matters of macro-economic import that impinge on one's immediate situation. Thus any prescriptive part of this unit must perforce be about ways of assimilating and using macro-economic information rather than a description of theory.

With this in mind, we will look at the process of analysis that was gone through in the preceding case, try to generalize it and then use it when considering the demography case in Section 5. Taking note of the extreme variety of situations in which the model would need to be employed, we should expect a very general 'recipe' of action steps. The model is called 4IA (for-eye-ay); it is shown in Figure 3 and then expanded in the following text.

### 4.1 Information Acquisition

When analysing and planning to cope with large-scale policy effects, the majority of us do not have access to internal government documents, or even practical access to relevant academic literature. But in most cases such sources are unnecessary. In the EMU discussion the core data were gathered from sources that can be tapped by most people.

As this unit was written in the UK, the national 'serious' press was the main provider – notably *The Economist* and the *Financial Times*. Both are available throughout the EU, and all countries have their own admirable equivalents, e.g. *Frankfurter Handelsblatt* in Germany, *Les Echos* in France, *The Wall Street Journal* in the USA, *Far Eastern Economic Review* in the Orient, etc. This source was supplemented by a few books on the subject purchased from 'serious' but general bookstores; the information for the demography case in Section 5 was drawn *entirely* from UK press sources.

![Figure 3 The 4IA Model](image-url)
It is worth noting that with modern technology it is much easier to search through journals than it used to be. Most major titles are available electronically, through either an on-line database or CD-ROM (the latter was used primarily for these examples). There are even on-line database systems (e.g. Textline) that will search a very wide range of sources all in one go. Of course, it is not to be expected that every organization will subscribe on a regular basis to a wide range of such data stores but, as prices for hardware and software continue to fall (quite dramatically in some cases), it will be cost-effective for all but the very smallest business to gain access to at least one such general news and analysis source. Furthermore, most of the more specialized systems are available on a pay-per-use basis – dearer per search than a regular subscription but a realistic option for the occasional user. Lastly, many of these methods of providing information are becoming available through public libraries and the like, so a modem or CD-ROM player may not be needed for the computer – although the convenience of having such equipment to hand tends to increase the actual number of information searches made.

### 4.2 Interpret and Analyse

Having completed the initial information search one must start to make use of the data garnered. The first search will probably not be comprehensive. It is usual to repeat Stages 1 and 2 until one is finally satisfied that the necessary package of information, interpretation and analysis is complete – an iterative process.

At this stage of the process one should be looking at the situation as a general problem. It is important with most macro-economic cases to start by analysing it in an ‘Olympian’ way without reference to one’s own organization or situation; if one narrows the focus of investigation too soon one runs a significant risk of missing important factors. The output of this ‘box’ of the 4IA model should be an interpretation of the macro-economic event that covers all the main implications, while avoiding the fall into an ‘analysis paralysis’ trap.

### 4.3 Identify Applicability

Having produced a neutral, global interpretation of the matter at hand by the end of Stage 2, now is the time to start making connections with one’s own situation. Such relationships may be immediately apparent or more convoluted. In fact, it is often most useful to investigate the more involved links since their very obscurity may decrease the possibility of their having been addressed already within the organization. This point is less true for brand new economic events, as few, if any, of the implications of a new situation will have yet been included in corporate policy.

Having identified the linkages with the ‘local’ business environment, one should then rank the list in terms of need for change in organizational activity.Crudely, most local influences fall into one of three categories:

- major impact, requires change to procedures
- minor impact, requires change to procedures
- major or minor impact, no change to procedures, keep watching the situation.
The first two categories can be further subdivided into changes required 'now' or 'in the future'; the third category should be looked at again to see if one can identify 'trigger events' that would move it into one of the other 'active' categories. By noting such pressure points one can reduce the need to watch the situation continuously – one needs simply to look out for the appearance of a trigger event.

### 4.4 Incorporate into Activity

The fourth stage makes the time and effort invested in the analysis of macro-economic events or situations worthwhile. The key premise is that forethought and planning rather than 'fire-fighting' should improve managerial response when the effects of such events filter down to the individual business environment.

The actions required can not be put into a general prescription but a 'rule of thumb' for ordering the moves can be suggested. Design all changes that are due to factors with major impact before any that are due to those with minor impact *even where implementation takes place in the order 'all "now" changes first'. The logic behind this is that the effect on procedures of all major impacts needs to be taken into account when planning reaction to the more minor effects, even if the 'now' sub-set of the latter will be implemented before the 'future' sub-set of the former. The design of all 'minor' alterations must reflect that of 'major' ones, irrespective of date of implementation.

### 4.5 Summary

The 4IA model is not comprehensive and is in some ways simplistic, but it has proved helpful in the past as a guideline for dealing with a set of analytical and implementational challenges that are too broad in scope for more prescriptive paradigms. Try it out either in the following optional activity or on the demography case in the next section.

**Activity 26 – Optional**

Think of a major macro-economic policy issue that is currently the subject of debate. In the same ways as we have done with EMU, analyse the pros and cons of the issue from the standpoint of your present business environment, using the 4IA model. What will be the impact for you, whichever way the decision goes? This activity is optional because it will probably be time-consuming if you do it thoroughly. However, working from scratch on a problem of your own choosing would be a better test of your reaction to the model than only trying it on the somewhat 'predigested' demography case in Section 5. A sensible compromise might be to postpone this activity until you finish this unit, when you will be able to gauge your available time more accurately.
5 Pensions and demographics

In the EMU case study we considered a key supra-national policy that will be decided one way or another quite soon, and which will have implications for all our business and personal lives. We will now consider a ‘sleeper’ case that will not maximize its effects for nearly 50 years, but which society needs to start tackling now.

The aim is the same as before: to give you practice in planning an individual and organizational response to broad macro-economic influences. This case adds another twist in that we should discover that the pensions policy ‘cause’ has profound ‘effects’ on the economic structure where the linkage would not be suspected without the careful sort of scrutiny propounded in this unit. The ‘ripple effect’ can produce surprising eddies.

5.1 The ‘granny boomers’

In 1990, 11% of the Japanese population was aged 65+, a lower percentage than in America or Western Europe; by 2010 that proportion will have risen to 18%, making Japan the ‘oldest’ country in the developed world. The 1987 West German census showed that by 2030 the country will have more pensioners than contributors (admittedly this was before reunification, but the demographic trends of the East and West are similar); for France the ‘crunch’ happens by 2020.

If the value of French pensions remains unchanged in real terms, the current contribution rate of 19% of payroll will rise to 31–42% by 2040. Italy spent 5% of GDP on pensions in 1960; by 1992 that was already up to just under 14% of GDP — and Italy at present has the lowest birth rate in the EU at 1.29 children per mother (the Union average is 1.57 — the ‘replacement rate’ is 2.1).

Incidentally, the much used term ‘granny boomers’ is not a sexist jibe but reflects the biological and statistical fact that women live longer than men. In Italy life expectancies are 72.6 years for men and 79.1 years for women. Yet retirement ages for women have typically been lower than for men, for understandable sociological reasons.

Write down the state and occupational retirement ages for men and women in your country. Have there been any alterations recently? Are there any planned for the future?

Funded versus ‘pay-as-you-go’ pensions

In most countries the state pension scheme runs on a ‘pay-as-you-go’ basis. The ‘contributions’ made by present workers are used to pay the benefits of current pensioners. No ‘nest egg’ is built up. This contrasts with a funded scheme where the contributions of current subscribers are invested to provide the source to fund their future pension withdrawals. All funded schemes are supposed to build up sufficient reserves to cover their actuarially predicted liabilities. This may be difficult for some forms of provision where such liabilities are not easy to forecast — we will consider the implications of such measurement later.
Activity 28

In a pay-as-you-go state system what is the difference between social security contributions and general payroll taxation?

Comment

Nothing—at least for the pensions element. So people who, for example, say that UK National Insurance contributions are just a hidden income tax have a justifiable case.

Activity 29

Countries X and Y both have pay-as-you-go state schemes but X also has a well developed funded pensions industry, whereas Y does not. What are the likely future implications if the demographic profile of both countries is similar to that laid out above?

Comment

In Country X there will be less dependence on the PAYG state scheme than in Country Y. Thus X will find it politically easier to restrict or reduce reliance on the potentially unsustainable state scheme, probably by offering incentives to workers to join funded schemes, either corporate or personal.

Europe has over £500 billion saved in pension funds— but the Netherlands and the UK account for 86% of that total. For that reason, the UK is only one of four OECD countries that is expected by 2020 to spend less than 10% of national income on pensions; the other three are Australia and ‘youthful’ Ireland and Turkey. This is based on the status quo being maintained.

Defined benefit and defined contribution

The practice to date for most EU corporate schemes has been to base the eventual pension on a proportion of the final salary (or average salary over the last few years of employment) defined by the length of service. These defined benefit or final salary schemes are popular but have an inherent flaw if one is trying to predict the cost of a future pension, which is very important when deciding the level of contribution required during the working career. Evidence shows that such schemes can be distorted by generous salary increments given by kindly employers ‘to boost your pension when you retire next year’. Such deals are not in themselves unreasonable if they are predictable and allowed for in earlier contribution rates, and if they are applied generally rather than to a favoured few. In practice, few cases satisfy either criterion.

The alternative to ‘final salary’ is money purchase, or defined contribution, where the ‘pot of gold’ is used to purchase stated benefits appropriate to the sum available, or the pension is paid from the income generated by the accumulated funds. Such systems leave no residual liability with the employer to make up any shortfall, as is usual with final salary schemes.
Who owns pension surpluses?

In the 1970s many ‘final salary’ schemes were left with substantial deficits by inflation, and companies had to top-up their pension funds. In the 1980s assets rose faster than predicted liabilities, leaving many funds in the UK and the USA with surpluses.

Companies say that since they are responsible for deficits they also own the surpluses. Many have been clawing back the money by various means. The most obvious is simply withdrawing the funds, but sometimes that has been challenged, and is in any case seen as too confrontational by many organizations. The same can be achieved by taking a ‘contributions holiday’ – the company stops paying in to the scheme for a number of years, which boosts reported profits. Another system is to fund redundancies via the pension scheme by enhancing benefits to early retirees. Again, costs that would impact on the profit statement are avoided. Moreover, money provided in this way has been a reserve that earns investment which is exempt from income-tax.

But who is to say that a particular scheme actually has a surplus? In the UK corporate disclosure about the pension scheme is set down in SSAP 24 (Statements of Standard Accounting Practice) that came into force in 1988 – before that there were no specific requirements. The Statement requires an actuarial valuation for final salary (or ‘defined benefits’) schemes, which will show whether the funds are sufficient to match the predicted liabilities. But, to quote the Pension Research Accountants Group: ‘The standard in its current form allows employers a great deal of flexibility to adjust results on a short-term basis, substantially impairs an informed reader’s ability to make judgements about annual pension costs and in practice prevents any general attempt to compare one employer’s pension cost figures with another’s.’ Or to measure the true size of any surplus.

Activity 30

What is the rationale for allowing companies to – one way or another – remove pension fund surpluses?

Comment

If they could not do so they would ensure that funds were kept in deficit, so as not to put in excess funds that they could not recoup, relying on their guarantee to make up any shortfall should any pensions not be covered when the time came. Clearly, this is not as safe a situation for the future pensioners as their having a fully funded scheme – so companies are permitted to redress surpluses, within certain guidelines (which could usefully be clarified).

Activity 31

Consider your own pension rights. What proportions are from personal, corporate and state sources? What proportion comes from funded sources? How much of this will be ‘final salary’ based, as opposed to ‘money purchase’? Are you confident that your rights will be the same when you actually reach retirement?

In Germany, the system instigated after the hyper-inflation of the 1920s encourages companies to make ‘book reserves’ against pension liabilities they promise to employees (these promises are state guaranteed in the event of bankruptcy). The contributions to these reserves can be deducted from taxable profit, but the reserves themselves can be utilized by the company as they see fit, rather than be entrusted to an investment manager.
Pension reserves and corporate ownership

The effect of the German use of company reserves for pension savings on corporate ownership has been profound. A similar situation exists in Japan, although they changed their tax law in 1980 to encourage funding instead.

Investment funds must be used to maximize the gains accruing to beneficiaries; reserves can be invested as the company sees fit. With a young workforce a company will be generating much more in the way of reserves than it is paying out, and the senior management chooses how to use the difference.

In practice this has provided funds to buy stakes in friendly companies, so both Germany and Japan are dominated by families of firms with cross-shareholdings. This shields firms from hostile take-overs, and has helped foster strong relationships between producers and suppliers.

However, as the countries' workforces age, the funds flow will reverse. The groupings will have difficulty in fulfilling all their pension obligations while keeping the friendly shareholdings.

So one of the key differences between the post-War 'economic miracle' countries and their competitors has been substantially aided by the pension funding system - and the same system could work to defeat the structure in the future.

So one unexpected implication of pension funding policy has been the structure of corporate Germany and Japan. It is not claimed that this was the only cause of the company groupings system we see, but it can be taken as a contributing factor that helped to make it possible.

Similarly, there is a strong correlation between countries which have significant pools of pension funds and countries which have well developed stock markets - indeed with particularly sophisticated financial markets generally. The USA and the UK are clear examples which have both, and the Japanese markets have grown much more rapidly since the corporations shifted to building up funds for pensions provision. Germany shows the other end of the scale; there is no claim that the combined German stock market is inferior, simply that it is smaller relative to the German economy than those of the UK or the USA.

It has been mentioned that, since 1980, Japan has switched the emphasis from internal pension reserves to funded schemes. This has meant that the country's corporations have had to build up the investment pools from scratch. What effect does that have on corporate costs and competitiveness? At present, pension contributions add US$87 to the cost of every Honda car; in contrast, the pension fund surpluses in Detroit mean that, for now, pensions add nothing to the cost of an American-built Ford or General Motors car.

Germany will have a similar cost penalty as its workforce ages, driven by their accounting rules. These allow German companies to set aside lower proportions of an employee's wages for pension provision when he or she is under 55, compared to the UK - but for 55-64 year olds the advantage swings the other way. For a 64-year-old employee a British company will set aside 26% of pay, a German company 34%.

As Germany has a much steeper 'population ageing profile' than the UK, it has benefited from its accounting rule in the past but will suffer reduced competitiveness in the future. Demographics can have significant implications for wage costs even before allowing for retirement provisions. The traditional Japanese system of pay according to rank, and rank according to years of service, kept the wage bill down while the workforce was young, but will now start to have the opposite effect.
5.2 Planning for the future

You have read enough about the looming problem. It is now time to consider what we should be doing to deal with the situation. While we could go into much more detail and provide a great deal of statistics it would not necessarily be beneficial. We – at least most of us – are not government ministers or senior civil servants, so we should be considering what to do at the organizational level. And what do we tell those who are at the top of the policy-making ‘tree’?

Activity 32

Assume that you are a manager in (and citizen of) an EC country that does not have a substantial store of pension funds, either private or public sector, and a looming demographic problem of a severity similar to that of France, Italy or Germany.

(a) What coherent set of policies would you expect your government to instigate over the next five years to deal with future provision for retirement?

(b) What strategy would you design for your current organization to cope with your predicted set of government actions?

When considering your set of actions please give due thought to the sociological implications of steps taken principally for economic reasons – and vice versa.

Activity 33

Answer the same questions as in Activity 32, but now place yourself in a country such as the UK which has a large (but not universal), private sector funded pension provision and a less extreme demographic ‘population ageing’ outlook.

The following is just one possible answer to the government-level questions posed in Activities 32 and 33. Your list will probably be very different, not least because you will have produced it from a starting point based on a political and an economic environment that is probably quite divergent from that pertaining at the time of writing this unit. So the following is a personal list, not a prescription.

One social solution applicable to both country scenarios posed, and one that has the weight of historical precedent behind it, would be to ‘reset’ the demographic clock by allowing in large numbers of immigrants, who tend to be young and productive (both economically and biologically). Such methods have worked in the past where there was perceived underpopulation, i.e. available room. The Union’s problem is not one of too few people overall but of too much grey hair within the indigenous population.

The estimates of numbers show why this way of removing the crunch would be unlikely to be politically feasible. To balance the greying of the present inhabitants would require an increase in the expected EU labour force of about 20 million people; if demand for workers led to unemployment falling from 9% to 6%, that would provide 6 million. Raising female participation from the present EU level of 50% to America’s 60% would provide another 6 million. This would leave a need for immigration of about 8 million workers, plus dependants. It might be possible to push female working towards 70% (the Japanese level); on the other hand, no allowance has been made for the increased number of people needed to look after the larger old-age population. So overall a guessestimate of about 8 million plus seems to be of the right order of magnitude.
Would such an influx be accepted by the indigenous peoples? In my opinion, no. At the time of writing France is just starting a government debate on a proposed law to tighten eligibility to citizenship. Recently Germany has suffered attacks on immigrants, and the British government not long ago had some difficulty about possibly letting in 50,000 Hong Kong citizens (plus dependants). The peoples of the Union could decide in the future that they would prefer to be a little more crowded (adding 8 million plus to the roughly 300 million already within the EU's borders) than to give up any pension entitlements, or to save more to preserve those 'rights'. As was said earlier, I do not believe this would happen, and thus do not regard this way out to be a political possibility.

In any event, is immigration not just a postponement of the difficulty? Would we not simply be bequeathing a still more intransigent problem to the next generation, which would not be an ethically acceptable solution in my personal opinion? A similar moral argument could be made against any plan to induce us to breed ourselves out of the difficulty, although perhaps encouragement to rise from the present average of 1.57 births per mother to the replacement level of 2.1 would be more justified. But this could make it yet more difficult to improve the female participation rate in the workforce!

An alternative social palliative would be to raise the retirement age. At present (April 1993) efforts towards this are patchy. A major debate is starting in the UK about the government's aim to fulfil an equal rights adjudication by the European Court by raising the female retirement age from 60 to match the male level of 65. Many companies are following suit with occupational schemes – and there is already much talk (and some rhetoric) about fairness and 'natural justice', which usually ignores uncomfortable facts about where the resources will come from. Germany raised its retirement age to 65 in 1989; in Denmark people work until they are 67. On the other hand, Italy has done nothing to implement a plan to go to 65 from the present 60 for men and 55 for women. Nevertheless, people are generally healthier and fitter than their parents, so it seems likely that, as the costs to society become more and more evident, it will become politically acceptable to raise the age at which we retire.

There could also be encouragement for some form of 'soft' retirement between, say, 65 and 70 – part-time employment to top-up a part-pension. There is evidence that people in their 60s and 70s can out-perform those in their 20s on tasks that are familiar – although not those in their 30s and early 40s who are, on average, at their peak performance.

All of the above applies equally well to all EU countries whether or not they have built up a store of wealth to pay for the future. The transition will probably be easier for the Netherlands and the UK who do have considerable 'nest eggs' already saved, but even they could usefully do more to persuade people to provide for their own old age rather than rely on the state.

For countries that have not been so parsimonious in the past, building provision in the future will be harder but will have to be undertaken (in my opinion). An immediate difficulty that this is likely to raise – it has already started to do so in France – is how to persuade current workers to 'pay twice'. Their present social security 'contributions' will still be needed to pay for today's pensioners, and they must subscribe again to pay for themselves in the future. A case of the sins of the political past being heaped on the present?

However, it is not all gloom. The instigation and generation of substantial savings pools should encourage the development of the financial markets and industry in the relevant nations. The open(ish) market in financial services could
also provide export opportunities for the UK and the Netherlands, which might help to improve the former’s intra-EU trade balance. This in turn could make it easier for the UK to participate in EMU.

A shift towards funding would have wider implications for the relative competitiveness of industry, following the reasoning in the Honda car example earlier in this case. It could be said that the UK and the Netherlands have been ‘unfairly’ disadvantaged in the past because their prudent provisioning and more balanced age profile have imposed excess costs compared to their pay-as-you-go Union colleagues.

This will ‘correct’ itself in the future, but it raises a possible item of friction amongst The Twelve (or Fourteen, Eighteen, Twenty-four – whatever club membership the years may bring). One perfectly feasible scenario of closer Union ties – perhaps Offspring of the Social Chapter from the Treaty of Maastricht – would involve some convergence of social provision. When the demographics were against it, the UK had to pay its own way. Unless carefully costed and implemented, an EU-level scheme could make the British also pay for the future demographic difficulties of the French and Germans. It is not an attack on the latter two nations, or ignoring the rights and problems of the other EU members, to consider a scenario that could impose unwarranted strains on the Union.

Forewarned is forearmed and it is by thinking and talking about such items before drawing up policies that we ensure this sort of quite esoteric point does not blow up into a crisis.

### 5.3 Summary

You have been asked to practise the skill of drawing out personal-level implications of very large-scale events, as described in the preceding paragraph, to help you avoid hidden pitfalls such as the possibility of a totally unnecessary intra-EU row. It is the process that is important: gather data, analyse ‘macro’ ramifications, search for unexpected effects, interpret for own environment, design strategy accordingly, instigate action. The cases should have proved interesting and useful, but they are just examples.

We started this unit by looking at what should be a clear and well structured form of performance measurement and concomitant evaluation – that for financial reporting. Yet even there the systems available have difficulty in giving us a meaningful and usable representation unless we know a great deal about the assumptions underlying their creation and calculation. The world is not simple and straightforward, and so neither can be the tools for dealing with it.

When we then started to look wider still our view of the wood and the trees risked becoming confused. Thus the key thrust of your work has not been to assimilate any particular arcane macro-economic theory but to arm yourself with some analytical skill with which to draw out the personal effects of global causes. In essence, a way to make sense of the political and economic slings and arrows with which we must contend if we are to make our outrageous fortune.
References


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Text


Figures


Tables