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"Without fear and without favour"

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5

An indefensible defence strategy

UK's military remains financially overstretched

Liam Fox promised that October's defence review would be a "clean break" for Britain's military establishment. There would be cuts, sure enough, but also the promise of a brighter future.

Well, cuts there have certainly been: the review imposed real reductions of 8 per cent on the armed forces' budget over the next four years. But the brighter future is proving harder to perceive.

A particular concern is that the defence secretary has not explained how he will prune the "unaffordable" £38bn of unfunded equipment orders he inherited. Rather, he has pushed this question out to 2015, beyond the scope of the defence review. However difficult the spending squeeze in Whitehall, this is a poor decision.

Procrastinating on these orders makes it impossible for the UK to set out a sensible military procurement strategy for coming years. Britain's defence industry, which had been looking for clarity from the review, still lacks the tools to plan for the future. That is bad for the armed forces, undermines the defence-industrial base and may ultimately weaken Britain as a military power.

Of the giant overhang, the coalition estimated that about £20bn related to equipment programmes to be paid for between 2010 and 2020. This has now been shunted into the five years beyond 2015, meaning the shortfall must be absorbed in half the time.

Deferring this expenditure will, of course, lead to additional costs. The government will have to pay industry to keep idle capacity ticking over while it waits for the delayed orders to be placed. The final total will be even higher.

It is hard to see how this bill can be met. The armed forces and the defence industry are clinging to some vague assurances given by David Cameron that military spending might rise in real terms after 2015. But the scale of the increase needed would be truly heroic. In effect, you would be talking about effectively doubling the rate of equipment spending simply to close the gap. In the absence of a major international crisis, this does not look politically viable.

Moreover, a heroic effort would be required simply to deliver the forces the coalition says that it wants for 2020. And it would suffice only if efficiency savings were achieved elsewhere in the defence budget – most notably through the £4bn or so reduction in personnel and basing costs that the Ministry of Defence hopes to achieve over the next five years. Any slippage and the gap would widen further.

This would only fund the military's legacy wish list – including the Joint Strike Fighter, Trident and the FRES armoured vehicle programme. There would be no scope to respond to any changing military needs – for instance to develop cyber capability or unmanned combat aircraft.

The idea these decisions represent the basis of a new, realistic defence strategy is hot air. They offer no possibility to reshape the MoD's relationship with industry – or to develop new capabilities that the UK may need in future.

Indeed, what Mr Fox has done is to ensure a continuation of the constant squeeze the defence industry has faced since 2005, when the UK's last under-funded defence industrial strategy was triumphantly unveiled.

Mr Fox's policy of dither has several undesirable consequences. First, Britain will continue to pursue a raft of unaffordable defence projects. Some will inevitably be cancelled after large sums have been spent on development. This will lower public confidence in procurement and make it harder to increase military spending at all.

Liam Fox must identify the programmes to be cut and set a sensible profile for spending

Second, the defence industry will remain on a drip-feed, and will doubtless respond by withdrawing further capacity. This may by default erode vital strategic capabilities that Britain wishes to preserve.

Third, the MoD will cut the things that are easiest – such as the research budget. This is especially short-sighted as it risks progressively degrading Britain's ability to develop cutting-edge weaponry.

Britain needs a properly worked out defence strategy. This means defining what it wants the armed forces to do, what kit they need and, by extension, what indigenous technologies are required for strategic reasons. The defence review did not adequately answer these questions. Mr Fox must bring more clarity.

He must also now identify the programmes that should be cut and create a sensible profile for defence spending, which can be properly funded. Only when he has done this can Mr Fox claim to have delivered the clean break that he originally promised.

Euro crisis calls for a fresh approach

European Central Bank should purchase more bonds

The European Central Bank's governing council meets today amid a sovereign debt and banking crisis tearing at the edges of the eurozone. It is in the council's hands to help safeguard the monetary union's stability – or to make matters worse.

The ECB will keep interest rates unchanged; anything else would be insane. Growth is picking up in the eurozone core, but it remains vulnerable to the conflagrations in Europe's financial sector.

On extraordinary liquidity measures, the ECB had been moving cautiously towards the exit. It is in principle desirable to wean private banks off unlimited liquidity provision. But when bond market fears have thrust banks into an acute funding drought, the psychological effect of carrying on with the exit strategy could be devastating. The ECB should state clearly that it will keep three-month unlimited facilities active until solvent banks are again welcome in the markets.

That requires Frankfurt to shed its excessive nervousness about lending to liquidity-squeezed banks – that is, doing its job as the eurozone's unique lender of last resort. This nervousness shaped the Irish rescue package, meant to somehow staunch a haemorrhage from sovereign bonds by sending Dublin deeper into debt for the sake of wobbly banks' creditors. This only pushed sovereign yields higher and further undermined the stability of Europe's banking system.

Patrick Honohan, Ireland's central bank governor, has described a "quid pro quo" in which Dublin renounced a belated interest in haircuts for bank creditors in order for the ECB's "liberal attitude" to funding Irish banks to last a little longer. That is intolerable.

The ECB should not resist lending going to just a few countries if that is where the liquidity crisis is. Frankfurt limits its credit risk by marking to market and imposing haircuts; it should not do so by pressuring governments to bail out banks. Of course, the ECB must withdraw funding from insolvent banks. But how to allocate the ineluctable losses between taxpayers and creditors is a decision elected politicians must take, not Frankfurt's central bankers.

It is in any case too late to tackle the sovereign debt crisis by indirect means. The best option left for the ECB is to extend its outright purchases of sovereign debt. The FT has earlier warned against trying to narrow sovereign spreads, an economically risky and politically toxic policy. But the risks of not acting are greater still, and the politics of sovereign default incalculably worse than grumbles about monetising deficits.

This crisis cannot be solved in Frankfurt alone. Eurozone governments have been more derelict in their duty than the ECB. The European Financial Stability Facility was meant to awe markets into submission so it would not have to be tapped; but its size is already seen as insufficient. The ECB can help. Publicly declaring its willingness to buy EFSF bonds when they are issued will remove any doubts about the EFSF's funding ability. If this encourages governments to expand it, so much the better.

Letters

Recent practice proves theory that banks need to improve equity

From Prof Martin Hellwig.

Sir, David Miles' article "Banks fail to convince crying foul over Basel reforms" (Comment, November 24) seems to have touched a raw nerve. Three letters (November 29) protest at his reliance on the Modigliani-Miller irrelevance propositions – with arguments reflecting banking interests rather than economic analysis.

Simon Samuels and Simon Gleeson argue that banks' borrowing costs tend to be independent of their equity. With government bail-out guarantees, you would expect them to be, even in a Modigliani-Miller world. Modigliani and Miller do not claim irrelevance of capital structure altogether. Their theory only claims that capital structure matters because of factors such as taxes and subsidies, bankruptcy costs and moral hazard, rather than the simple mechanics of the division of cash flows between debt holders and shareholders. But then, because of those very factors, there is a difference between the private and social costs of bank equity.

Bail-out guarantees create an implicit subsidy to banks. The value of this subsidy is the greater the less banks are relying on equity finance and the more risks banks take.

From a social perspective, therefore, banks' funding choices are distorted towards an excess of leverage. Further distortions come from the differential tax treatment of dividends and interest payments and from the costs bank bankruptcies impose on third parties.

If banks consider equity finance to be expensive, one of the main reasons is that they fail to consider the effects on taxpayers or the risks they impose on the rest of the financial system and the overall economy. Regulatory capital requirements try to counteract these distortions.

Richard Barwell of the Royal Bank of Scotland criticises such regulation on the grounds that one distortion does not justify another distortion; in effect, he is saying that it would be unfair to impose a limit on pollution when there is a feature of the tax system that subsidises it.

Your correspondents all insist that that this is a matter where practice has more to teach than theory. The practice of banking in the past few years has certainly taught us many lessons. One of them is that banks' economising on equity is a source of fragility of the financial system that puts all of us at risk. This side of banking practice is overlooked by your correspondents.

Martin Hellwig,
Director,
Max Planck Institute for Research on Collective Goods,
Bonn, Germany

Highly leveraged lenders inflict great suffering on society

From Prof Anat Admati.

Sir, David Miles' Comment article ("Banks fail to convince crying foul over Basel reforms", November 24) and his follow-up letter (November 30) in response to letters by Richard Barwell, Simon Gleeson and Simon Samuels on November 29 are refreshing, particularly following Citigroup chief executive Vikram Pandit's previous Comment "We must rethink Basel, or growth will suffer" (November 11). Unlike Mr Pandit and the November 29 correspondents, Prof Miles focuses on the logical arguments.

Mr Samuels uses a quote by baseball star Yogi Berra to dismiss Prof Miles' arguments as theoretical and inapplicable to practice. But Berra is also famous for instructing a waiter to cut his pizza into six slices because he was "not hungry enough for eight slices". This is funny precisely because the size of a given pie doesn't depend on how many slices it is cut into, an exact analogue to Modigliani and Miller's result. This is true in theory and no less true in practice. The reason high leverage lowers banks' funding costs is that the more debt banks use relative to equity in their funding, the smaller is the slice the government takes in taxes, and the higher is the value of the implicit or explicit guarantees the government provides to their debt. Highly leveraged banks, particularly those too important to fail, have strong incentives to take on excessive risk, enjoying the upside without having to worry about the downside of their bets. Given the fragility and systemic risk that high bank leverage entails in our interconnected financial system, society suffers greatly when banks are highly leveraged, even as banks and their managers benefit. When it comes to banks and their leverage, there are no practical considerations associated with bank funding that provide any reason for the public to allow banks to be anywhere near as highly leveraged as they would like to be.

Messrs Pandit, Barwell, Gleeson and Samuels must do more than dismiss arguments as theoretical and raise vague and unsubstantiated threats to global growth and the economy. They must explain precisely what forces should lead society away from imposing high equity requirements on banks and how such an effect comes about. Unless and until they do so, it is their arguments that should be dismissed, not those of Prof Miles.

Anat Admati,
George G.C. Parker Professor of Finance and Economics,
Graduate School of Business,
Stanford University,
Stanford, CA, US

The real world is rather pro-cyclical

From Mr Ronit Ghose.

Sir, David Miles and Andrew Smithers (November 24 and 30) argue that higher equity capital is unlikely to have a material impact on banking. Perhaps in the academics' study the world is anti-cyclical, but in the real world it is usually rather pro-cyclical. Look at the experience of UK or Nordic mortgages when banks moved from Basel I to Basel II: capital levels fell dramatically and so did lending margins.

And what happened when risk returned during the global financial crisis? Yes, margins went up – whether in French mortgages or in Asian foreign exchange.

We may theorise in an anti-cyclical world. But we live in a pro-cyclical one.

Ronit Ghose,
London SW1, UK

A free (stolen) breakfast

Goldilocks did well for herself

From Mr Jon Zigmond.

Sir, Lex ("Global inflation", November 29) notes "as Goldilocks discovered to her cost, there is no such thing as a free lunch".

In the traditional version of the story Goldilocks had a breakfast of porridge (as well as a lie down) at no cost to her, before running away when the three bears returned home.

The moral? Apparently a free (stolen) breakfast – and no bad press – is possible.

Jon Zigmond,
Rosedale Abbey, N Yorks, UK

A good year for swans and cygnets

From Mr Robert Simons.

Sir, 2010 has been a very good year for swans, both black and white (Letters, November 29). On the Grand Union Canal at Linslade this year a pair has hatched and raised eight cygnets: a 10-white-swan event.

Robert Simons,
Leighton Buzzard, Beds, UK

Crisis that is prolonging the misery

From Mr Jeremy Beckwith.

Sir, Martin Wolf correctly identifies the euro as being in a joint credit and competitiveness crisis ("Why the Irish crisis is a huge test for the eurozone", December 1), but neglects to consider the implications of the competitiveness crisis. A credit crisis can be resolved through debt restructuring without necessarily imperilling the euro, but a competitiveness crisis is not so easily dealt with.

Since the inception of the euro, German average unit labour costs have grown by about 25 per cent less than in the Mediterranean countries, resulting in massive trade imbalances between Germany and these economies. To restore the balance requires either very rapid German wage gains (not really a speciality of German business in recent decades) or sharp wage and employment cuts in the other economies, or of course a change in the exchange rate.

Merely resolving the credit crisis but leaving the competitiveness crisis intact will simply prolong the misery in the Mediterranean countries as workers remain unemployed, and lead to further credit crises.

The choices for the politicians are clear but all are unpalatable (aside perhaps from full political and fiscal union) – inflation in Germany, depression in the periphery or the end of the euro.

Jeremy Beckwith,
Chief Investment Officer,
Kleinwort Benson,
London EC2, UK

Please – spare us the charm, bankers

From Mr Ronel Lehmann.

Sir, Forgive me, but the last thing that we now need is a "charm offensive" from bankers (report, November 26).

The British Bankers' Association bleats on about banks approving 85 per cent of credit applications, businesses not wanting to borrow, Basel III, the need for new entrants in the marketplace, a new venture capital fund and a task force committed to lending, but my own experience is that a company that has always enjoyed working capital facilities for 22 years simply cannot obtain any and is forced to operate in credit.

If the government can get the banks lending again, in spite of their protestations that they are, businesses up and down the land will contribute and help to accelerate the economic recovery. Maybe only then our perception of bankers will finally begin to soften.

Ronel Lehmann,
Chief Executive,
Lehmann Communications,
London EC3, UK

The Britishness of Brendan Bracken

From Mr Colin Joyce.

Sir, Mary Ellen Synon (Letters, November 26) correctly points out that Brendan Bracken, late founder of this newspaper, was the son of an Irish republican father. She neglected to point out that Bracken was also a Tory MP, best friend of Winston Churchill, privy councillor, lord of the admiralty and a British peer.

He became perhaps more "British than the British themselves".

Colin Joyce,
Rosscahill, Co Galway, Ireland

Clear boards of undeserving men

From Dr Julie Bower.

Sir, Miles Templeman's contribution to the discussion on women in boardrooms (Letters, November 30) does little to further the debate. His assertion that female board members would be "tainted with the suspicion that they had not been appointed on the basis of merit" raises the question how so many men were appointed. If, as he says, "appropriately qualified female directors have as much to offer the boardroom as their male equivalents" there should already be an equal number of women on boards. Given the huge imbalance, I find it hard to believe that all men on boards were appointed on merit.

This has gone on long enough; the only solution is a mandatory quota system with a phased increase over, say, a 10-year period to address his main concern that women are appointed on merit and to clear out the men who clearly were not.

Julie Bower,
Worcester, UK

Correction

● The December 1 Lombard column said Schroders had returned to profitability last year. In fact, the asset manager made pre-tax profits of £123.1m in 2008 and has been profitable since 2002.

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Notebook

James Crabtree

Tales from inside the bunker

With his name appearing in the latest WikiLeaks dump, and with his book on the crisis due next week, Gordon Brown is back in the news. Wednesday's leaks were hardly revelatory, with Brown reported to be reluctant to send more troops to Afghanistan and contemplating cost-saving cuts to Britain's submarine fleet. More intriguing are the nuggets hidden in *Brown at 10*, Anthony Seldon and Guy Lodge's intriguing book on Brown's brief premiership.

The dust jacket claims his three years "were the most turbulent of any premiership in the postwar history". If so, the authors suggest Mr Brown must share blame for the chaos within. Indeed, he reportedly carried with him a bag filled with random speech drafts and half-read reports, known to his despairing aides simply as his "mad bag". For fear he might look disorganised in public, the bag was carried concealed by an aide, only for prime minister and receptacle to be reunited when out of the eye of the cameras.

Transatlantic ties might currently be strained by ongoing leaks, but relations between the White House and Britain's press were equally rocky during Mr Brown's term. Barack Obama's team despaired at the imagined snubs dreamed up in Fleet Street during dealings between president and prime minister. Rahm Emanuel, Mr Obama's former chief of staff and a man with a well-earned reputation for coarse language, is quoted berating Mr Brown's press team thus: "Your press are criminals. What do we have to do to convince them about our special relationship? Do they want pictures of Gordon getting it on with Michelle in the Oval Office?"

Throughout, the book paints a bleak picture of a Brown administration beset on all sides. But there are lighter moments. On an early visit to Camp David, Mr Brown was determined not to look "pally" with George W. Bush. He suggested both wore suits, and avoid the relaxed behaviour favoured by Tony Blair on such occasions. To wind him up, when Mr Brown arrived Mr Bush picked him up in a golf cart regardless. Yet perhaps the most unlikely comic turn came in Northern Ireland. In February 2010 Mr Brown had flown to Hillsborough to announce plans for the devolution of policing and justice. Thinking of his remarks, he wondered how he might emulate Mr Blair's much derided phrase: "A day like today is not a day for sound bites . . . but I feel the hand of history upon our shoulder." With fierce negotiations with Northern Ireland's first minister and others on his mind, Mr Brown joked he might try: "I feel the hand of Peter Robinson in my pocket, and the hands of Gerry Adams on my balls."

Brown snow

Brown's tenure might also hold a few lessons for those dealing with recent wintry weather. Last January Britain suffered even heavier downfalls. Salt supplies ran so low that the government was reported to have ordered local councils to reduce gritting, to preserve what remained. So dire was the situation that contingency plans were drawn up to close stretches of motorway. Mr Brown thought this madness, and instead rang up José Luis Rodríguez Zapatero, Spanish prime minister, and personally placed an order for more salt. Had Britain's long-suffering commuters known of this side to the prime minister's reputation for micromanagement, they might have viewed him in a more positive light.

'Do you have to bring that sort of diplomatic language home with you?'

PMSU, RIP

The Prime Minister's Strategy Unit, the Cabinet Office think-tank set up by Tony Blair, is to be closed, with some of its staff heading off to beef up David Cameron's policy unit inside Number 10. Yet the disbanded advisers may soon be back, given the frequency of changes to the PM's staff over the years. The first comparable outfit was Lloyd George's "garden suburb", a unit started in 1916 when his small team of political advisers took up residence in wooden sheds in the Number 10 garden. As one account put it at the time, this "little body of illuminati" were meant to "emerge from their huts in Downing Street, like the competitors in a Chinese examination, with answers to our thousand questions of the Sphinx". Disbanded PMSU veterans should take heart at their longevity too. In its various incarnations they lasted for a decade. Lloyd George's wonks managed just two years before their shacks were knocked down.

james.crabtree@ft.com

Germany is right: bondholders must pay

Otmar Issing

Miscommunication has accompanied Europe's monetary union since the start. The economic crisis, however, has brought forth a Babel of voices. A recent example was the remark by Herman Van Rompuy, the European Union's president, that the debt crisis would put the survival of the union in question.

Now, most observers would apparently want to put at the top of the list of mistakes the announcement that holders of government bonds issued after 2013 should take losses in the event of a sovereign debt crisis.

As a consequence, the argument goes, uncertainty was increased and the bonds of Ireland, Portugal and Spain fell. Not everyone had the same opinion, but there seemed virtual unanimity that such a statement should not have been made until the crisis was over.

I would not suggest that the announcement deserves a Nobel prize in communication. But I think the timing and core message were appropriate.

First, it seems to me of crucial importance at this stage in the monetary union's development that if a permanent rescue mechanism is established we should also have a restructuring regime for sovereign debt that involves losses for private investors. Why should taxpayers be taken hostage endlessly by investors who enjoy the benefits of high interest rates and who can rely on being bailed out once an indebted country gets into trouble?

Default must be a credible threat – otherwise investors will have a strong incentive to buy bonds offering higher interest rates without taking into account the associated risks. We saw the consequences of such behaviour when, for a long period, the long-term interest rates for countries such as Germany and Greece hardly differed. Over many years, news about higher budget deficits and debt ratios that were far beyond the criteria set in the Maastricht treaty had no significant effect on interest rates. That encouraged countries to ignore the need for fiscal consolidation and contributed significantly to the current crisis.

Second, what about the argument that any announcement of a sovereign debt mechanism should have been delayed until the crisis was over? I would argue it was hardly premature. As long as investors can reasonably hope for a bail-out, investment decisions will be distorted by speculation about politically motivated intervention. The more markets are convinced that the EU or other authorities will support an economy in crisis, the larger will be the number of investment decisions based on such speculation – and the greater the risk of bank collapses if such support is not forthcoming. Pressure for "solidarity" will increase and "there is no alternative to a bail-out" will become a permanent mantra.

Default has to be credible – otherwise investors will have an incentive to buy bonds without taking into account the risks

The case of Germany's Landesbanken is a good example of what happens when the implementation of reforms is delayed. When it was announced that the phasing out of state guarantees would only become effective some years hence, the Landesbanken used their triple A ratings – which remained during the "grace period" – to issue large amounts of bonds at very low interest rates, which were invested in high-risk assets such as subprime mortgages. The results are only too visible in Germany's Landesbanken sector today.

No doubt, designing a sovereign default scheme is a tremendous challenge. But there is a consensus that a permanent crisis mechanism is needed in Europe's monetary union. Any agreement on a new fund – or whatever it is called – that does not include a debt restructuring clause involving private investors would be an invitation to markets to speculate on future bail-outs. It would undermine, if not destroy, the signals markets are sending about good and bad fiscal behaviour. The sanctions imposed by markets are needed more than ever because governments have refrained from strengthening the EU's stability and growth pact, which was meant to act as a political control on fiscal behaviour.

Outline proposals for a mechanism have now been presented. It seems, however, that private investors would have to take losses only in extreme cases and after ad hoc decisions. Which authority will judge that the debt position of a country is unsustainable and that a process of restructuring has to be started? Such a regime would lack credibility and predictability. It would be based on discretionary decisions and set the stage for future political tension, uncertainty and market volatility.

The writer is president of the Centre for Financial Studies and a former member of the European Central Bank's executive board

Less may be more in the age of the Clegg paradox

George Bridges

Nick Clegg poses something of a paradox to the governing coalition. His Liberal Democrats have fallen sharply in the polls as their support for spending cuts and student fees, those traditional mantras of the right, alienates supporters. Yet his authority in government has not diminished. If anything, it has grown. David Cameron knows too well he cannot allow Mr Clegg to retreat from their partnership, and so must give him more reasons to convince his party that he is delivering results.

The Clegg paradox is just one of the conundrums facing this surprisingly radical coalition as it begins to inflict the deepest spending cuts since the second world war. While many thought it came to power with a relatively cautious prospectus, in just six months it has outlined a bold economic plan and a radical shake-up of schools, the welfare system, the health service and the armed forces. It is a programme that cannot be accused of lacking ambition. If anything, it smacks of General Foch: "Hard pressed on my right. My centre is yielding. Impossible to manoeuvre. Situation excellent. I attack."

Engaging on so many fronts, however, has its risks. If the government machine is overloaded, ministers are also more likely to be caught unaware by the devil of policy detail. Here the coalition must heed its own strictures to the public sector: less is better.

Amid all the initiatives, creating a clear, coherent message is an increasing challenge, especially on the economy. For the first six months the coalition pressed the case for deficit reduction. Now it needs a clearer message on growth. George Osborne, the chancellor of the exchequer, began to set this out on Monday, with the promise of corporate tax reform – an implicit admission that fear of high taxes and regulation threatens an exodus of companies. His task now is to make his approach marketable on the doorsteps, not just in the boardrooms.

Engaging on so many fronts has risks. If the machine of government is overloaded, it is more likely to be caught out

In a coalition, however, clarity is not always helpful. Indeed, the clearer its message, the more difficult it often becomes to balance the conflicting views of its membership. The coalition wants to "rebalance" the economy, for instance. But it must also acknowledge that a strong financial service sector remains one of the best dynamos for growth in the short term. With the City bonus season coinciding with public sector cuts, this will mean the chancellor having to resist pressure from his government's business secretary, Vince Cable, for new regulations.

Yet differences within the two parties are as great, sometimes greater, than those between them – something that can be an unlikely source of strength for the leadership. There is obvious disagreement, for example, on how much power should be handed down to local authorities, schools and hospitals. Members of the Lib Dems' grassroots worry that local authorities may be bypassed, while some Conservatives fear for the future if Labour seizes control of more powerful local authorities in coming years. The quest for a radical transformation of the scope of the state, with private companies, mutuals and charities fulfilling roles currently undertaken by government, rests on overcoming these divisions – and ensuring ministers resist the temptation to meddle at the first screaming headline.

The coalition has shown so far that such differences can mostly be ironed out behind closed doors. The Lib Dems also remain a helpful shield from accusations that the cuts amount to a Tory reversion to Thatcherism, a still potent political charge. Yet both leaders also know the balance is precarious. If the Lib Dems fail to win May's referendum on the alternative vote, as polls currently suggest, further pressure will mount on Mr Clegg from activists unsure of what they are getting from the coalition.

This should worry Mr Cameron. It is true that both men remain locked together and have promised the coalition will endure the full five-year term. An early election would spell annihilation for the Lib Dems, while the Conservatives know they too would struggle to win an outright majority in this time of austerity. Yet while attacking on many fronts, the coalition must be mindful of the need for balance. The Clegg paradox won't rupture the coalition. But Tory diehards should beware of hailing his drop in the polls. Ultimately, if he is too weakened, the government's radical potential will be curtailed too.

The writer is a former campaign director for the Conservative party

Why the iPad should rival the web

John Gapper

Richard Branson and Rupert Murdoch are entrepreneurs with an admirable record of ignoring conventional wisdom, so it is worth watching when they do the same thing at once.

In this case, they are launching iPad-only publications. Sir Richard bowled into New York on Tuesday to unveil a £1.79 or $2.99 monthly magazine called Project, while Mr Murdoch is about to launch a "newspaper" called The Daily, for which he hopes 800,000 people will pay $1 a week. Both will charge readers in an era when most internet publications are free.

The fact that Mr Murdoch will separate his new daily publication from "the open web" by publishing on the iPad has provoked scepticism and hostility in digital media circles. "Murdoch keeps fighting the internet and the internet keeps on winning," wrote Mathew Ingram, of the GigaOm technology blog.

This fits into a bigger debate about whether companies are balkanising the web to gain economic leverage. Tim Berners-Lee, the British scientist who invented the World Wide Web, complained in Scientific American about Facebook's private accumulation of data, and of print publishers' "disturbing" wish to create closed worlds.

Yet, even leaving business models aside, it is hard to blame them. The truth is that, two decades after Sir Tim pioneered it, the internet has proven a poor medium for publishers who originate a lot of news and information. It has gone further than levelling the playing field between old-style publishers and start-ups – it has given the advantage to low-cost information providers.

This was less clear before the iPad and other tablets came along, but it stares you in the face when you compare the experience of reading a publication with a lot of content on a desktop and a tablet. A regular browser on a computer is good for skimming ("surfing") among many different news sources, but poor at immersing you in one.

In his book *The Shallows*, the technology writer Nicholas Carr talked of the internet's "uniquely rapid-fire mode of collecting and dispersing information" and argued that he was becoming accustomed "to take in information the way the net distributes it: in a swiftly moving stream of particles".

It goes without saying that the internet has great benefits in terms of the amount of information that can now be accessed directly, rather than being mediated by a newspaper or television news show. The idea that anyone could (if he or she chose) read the 250,000 US diplomatic cables soon to be made available by WikiLeaks would have been inconceivable two decades ago.

But there is no such thing as a neutral medium. Just as newspapers, radio and television offered different methods of presenting news and information, with varying degrees of depth, the internet favours some forms of content over others. People tend to skim the home pages of sites rather than delving deeply because browsers work that way.

If you try to dig far into a web publication, the pages often load slowly and it is hard to find your way out again, or even to know where you are within it. 'The web is an infinite experience. You never have a feeling for what the whole is," says John Rose, a partner of Boston Consulting Group.

This tends to favour shallow (I mean that technically, rather than as a value judgment) sites with a lot of aggregated material and links, such as Gawker and the Huffington Post, over those weighted towards deep stacks of original content. The line is blurring as upstarts shift towards producing more original material, but the point stands.

The iPad, with its full-screen apps containing a single game or information source changes that, as does the fact that an entire edition can be downloaded at once. This makes it easier to navigate in depth and to know where you are – an experience akin to print.

On a tablet, an edited, in-depth publication has a better chance of competing with the atomised, open-source information flow of the open web. That is what Sir Richard and Mr Murdoch have bet on – that a tablet restores the advantage of depth over breadth.

That may not be enough – many people are happy to live in the world of free, distributed information and will prefer it. "If you think that the day of the editor deciding what you read today is dead then these apps will fall apart," says Benedict Evans, of Enders Analysis.

My bet is that the two will co-exist, just as new forms of media have always done with existing ones in the past. There is evidence that people are willing to spend far longer – up to 45 minutes in the case of some magazines – with an iPad publication than its website.

Sir Tim would prefer publishers to stick to the rules, and the embedded biases, of the medium he pioneered. But, despite all of the public good the web has brought, that argument has no more moral force than if a print baron insisted on everyone producing newspapers.

If Sir Richard and Mr Murdoch want to offer products in a new medium rather than the old one, let them. It is not as if they have some iron grip over digital distribution. The iPad has a browser and they will be up against many thousands of other apps.

Who knows if either of them will succeed, but someone will find a way to get users and advertisers to pay for in-depth digital content delivered as an edited whole to the iPad. They will be competing with the browser, not fighting the internet. I can't see anything wrong with that.

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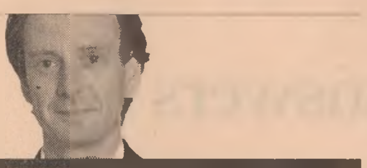
Beijing is not about to prise lips from teeth



David Pilling

You can imagine the scene in the Oval Office. "Mr President," says Kurt Campbell, US assistant secretary of state for east Asia. "I thought you should see this dispatch from Kathleen Stephens – you know, our ambassador to Seoul, Sir. She says that a guy named Chun Yung-woo, South Korea's vice-foreign minister, was speaking to a Chinese official who said that, get this Sir, North Korea has 'little value to China as a buffer state'." Mr Campbell pauses to let the significance of the fourth-hand statement sink in.

As far as intelligence goes, this is pretty thin gruel. In fact, it is the very definition of Chinese whispers. This and similar snippets from WikiLeaks are by no means sufficient to conclude, as some have done, that there has been a significant change of heart in Beijing. Suddenly, we are led to believe, China has grown weary of its tantrum-prone North Korean ally and is prepared to prise lips from teeth – Mao Zedong's favoured metaphor for the tight relationship – even at the cost of the North's reunification with the South.

Such a conclusion would be hasty indeed. Recent actions by China point to a different conclusion, although it is fair to say that attitudes to Pyongyang have hardened following its two nuclear tests in 2006 and 2009. Yet, significantly, the WikiLeaks cables dry up in February, a month before Pyongyang is thought to have torpedoed a South Korean naval vessel, the Cheonan, with the loss of 46 lives. If there had really been a change of heart, Beijing would surely have condemned that attack. Instead, it refused to accept the conclusions of an international inquiry fingering Pyongyang, and even rewarded Kim Jong-il, North Korea's leader, with an invitation to China.

Second, to interpret Mr Chun's remarks as somehow representative of a broad consensus in Beijing is to misunderstand the fractured nature of China's foreign policy. Michael Wesley, executive director of the Lowy Institute for International Policy, says that, as China's global economic and political interests grow more complex, "it is becoming impossible to talk about a grand Chinese position on anything."

On the North Korean issue, specifically, Mr Wesley sees a split between security-focused elements of the leadership, including those close to the People's Liberation Army, and less "hardline" foreign policy technocrats. There may also be a generational divide, he says, between those of President Hu Jintao's age, who hold "as an article of faith that China can't let its ally down", and younger Chinese officials embarrassed by a North Korea that looks like a parody of pre-1978 China.

The WikiLeaks cables are by no means sufficient evidence of a change of heart in Beijing towards its North Korean ally

Third, if anything, China has been seeking to reduce US influence in the region. Beijing has expressed anger at what it regards as US interference, for example in the South China Sea. A Wednesday editorial in the Global Times, an official tabloid, said of Washington's recent efforts at closer regional engagement: "Since the US declared its return to Asia, the frequency of clashes in the Korean Peninsula has accelerated. Instead of reflecting on this, South Korea became more obsessed with its military alliance with the US." This view is difficult to square with a more relaxed attitude towards reunification.

Fourth, Beijing seems to be trying to prod North Korea towards the type of economic measures that have driven its own success. John Delury, of the Asia Society, says the one consistent message from Chinese officials is that western sanctions do not work. Encouraging economic reform is consistent with a policy of trying to preserve North Korea as a going concern, rather than preparing for its collapse. Similarly, Beijing's apparent facilitation of North Korean weapons exports to Iran, also suggested by WikiLeaks cables, hardly points to a Chinese clampdown on Pyongyang.

Fifth, Lee Myung-bak, South Korea's president, does not seem to harbour any illusions about the likelihood of reunification. True, this year, he floated the idea of a tax to prepare South Korea's citizens for the possibility of a united Korea. But when I asked him about this last month, he stressed that the tax was more symbolic than real and that reunification would not happen for a very long time.

Finally, as Mr Delury points out, there may be a "good deal of wishful thinking" in seeking out Chinese officials prepared to express theoretical support for reunification. If there is one thing that should be clear from reading WikiLeaks cables, it is that diplomats are prepared to say one thing to their foreign interlocutors – and quite another behind their back.

Where does this leave us? Brian Myers, an expert on North Korea at Dongseo university, says the most interesting WikiLeaks revelation is that senior North Korean officials may have been defecting. Mr Myers argues that North Korea may well be on the brink of collapse, not because of succession issues but because of the regime's need to provide military "victories", the only thing it has to offer its people in the absence of a functioning economy. "The regime is basically on a collision course with the outside world," he says, arguing that it will be gone within a decade. If he is right, one precondition of reunification – regime collapse – may be closer than we think. But that is a very far cry from saying that China would welcome it.

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Business Life

One-minute management: the Matsuya fast food chain lowered costs by reducing the steps staff take to perform tasks and having customers use vending machines to order (below) Ko Sasaki

Survival in deflationary times

Japanese companies offer useful lessons in coping with a long-term decline in consumer spending and prices, says **Michiyo Nakamoto**

It is difficult to detect simply by having a meal at Ringer Hut, but the cabbages used at the Japanese restaurant group are more than double the size of those sold in grocery stores and supermarkets.

Ringer Hut, which specialises in a Nagasaki noodle dish known as champon, asked suppliers to grow the vegetables a month longer than usual, which makes them sweeter than conventionally sized cabbages.

But, crucially, the larger size of each cabbage head also lowers costs because the same volume can be sent in fewer boxes and there are not so many cores to remove, the company says.

Ringer Hut's request for larger cabbages was born from years of studying how to reduce costs and beat Japan's decades-long deflation.

"People have only one stomach, so [lowering prices] has an effect on customers," says Kazuhide Yonehama, the company's chairman.

For businesses in the US and Europe, which face the threat of a drawn-out period of deflation, the experience of Japanese companies may offer some useful lessons.

It has been 20 years since Japan's asset bubble popped and the economy began its long descent, and consumers have kept a tight grip on their spending. "The price of goods continues to fall and fall," says Takayuki Suzuki of Primo Research Japan, which provides research on the country's retail sector.

The price of a standard meal at Matsuya, one of Japan's largest fast-food restaurant groups, which specialises in gyudon beef-and-rice bowls, has fallen by 20 per cent in the past 10 years, from Y400 to Y320 ($3.80) today.

The businesses that have stayed on top are those that have managed to lower their prices by improving efficiencies and cutting costs aggressively.

Many of those companies have done so by employing techniques developed by Toyota, the carmaker, which preaches the eradication of waste and wasteful actions that lead to unnecessary costs.

Ringer Hut, for example, has been attending study sessions since 1994 on the Toyota system, which taught it to lower inventories to free up space and cut inventory costs.

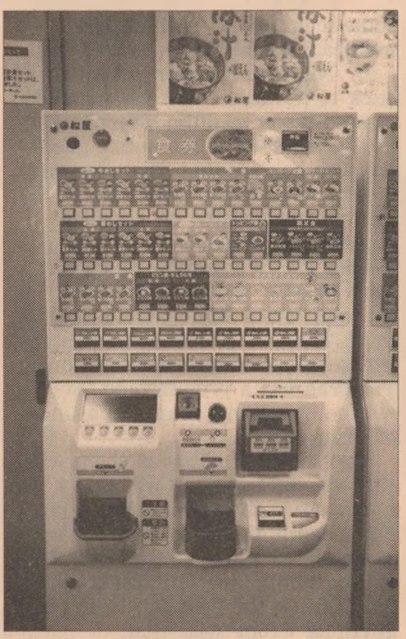
"When you join [the study group], the main thing that happens is inventories fall to half or even a third of previous levels," says Mr Yonehama. The sessions taught Ringer Hut to order two days' worth of chopsticks, rather than a week's worth, and 3kg of cabbages, rather than 15kg.

In another example of rethinking the model, instead of buying equipment, such as meat slicers, the restaurant group now makes its own. Mr Yonehama says: "The *sensei* [teacher of the Toyota system] said 'give me three months' and he made a meat slicer that cost just Y800,000, or one-10th of the Y8m that we used to pay before."

This is because commercially available slicers came with many unnecessary attachments, whereas Ringer Hut needed slicers to perform just one function – to cut meat in different sizes, Mr Yonehama says.

At Matsuya, every movement required by staff is carefully calculated as a way to eliminate waste and thereby lower costs – another practice popularised by Toyota.

"Reducing two steps, even one step, makes a huge difference in efficiency" because the restaurants are very small, says Masatoshi Sato, a director at Matsuya. "If you are in one spot and can do three tasks, it is more efficient than if you are moving around" to accomplish the same three things.



20 years

Time since Japan's asset bubble burst and the economy began to decline

Businesses that have stayed on top have lowered prices by improving efficiency

Efficiency enables more customers to eat at Matsuya restaurants every day. One way in which Matsuya has done this is by ensuring that everything staff need, from the rubbish bin to the duster, can be reached with the minimum number of movements. And once the best layout for everything is determined, the staff take pictures and memorise it.

Matsuya serves about 400,000 customers every day at its 800 restaurants, which are open 24 hours a day, 365 days a year.

"So, if the time that a customer spends in the restaurant is cut by one minute per customer, that is 400,000 minutes [the company is saving]," says Mr Sato.

Another way businesses have sought to improve efficiency and cut costs is by building a vertically integrated business model and realising economies of scale.

For example, says Mr Suzuki, "retailers such as Aeon, one of Japan's largest supermarket groups, buy products in bulk directly from manufacturers and bring the products directly from the manufacturers' factories to their own logistics centre, bypassing wholesalers' logistics centres". The company also buys the entire catch of certain fishing communities.

Nitori, a furniture store, not only makes its products at its own factories in China and Vietnam but has gone a step further than most and set up its own logistics system. Rather than ship products from China to a warehouse in Japan and then repackage them according to which Japanese store they are bound for, Nitori separates its products by store destination in China, where personnel costs are cheaper.

"By bringing shipping operations in-house, it is able to reduce not only shipping costs but warehousing costs as well," Mr Suzuki says.

Control of everything from manufacturing to distribution gives Nitori a better grasp of the costs and makes the whole process more efficient.

Efficiency is also the key to the success of Hajime Construction, which has avoided the fate of many failed housebuilders by moving its products faster than its peers.

"The most important thing in the deflationary environment is to cut the lead time [from land acquisition to house sales]," says Kimiyoshi Koizumi, president of the housebuilder, which has grown rapidly in Japan's deflationary environment by providing low-priced housing.

The average amount of time from when it acquires land to when it recoups its investment through sales is 129 days, including the construction time. This is much shorter than its competitors, which can take as long as a year to do the same, says Mr Koizumi.

Hajime is a so-called "power builder", which means it builds about 1,000 units a year and thereby manages to keep its costs down by having huge economies of scale. Hajime is also quick to cut prices "dramatically and quickly" if sales are not going as planned, Mr Koizumi says.

While the downward pressure on prices continues, after two decades of deflation, a new trend is emerging alongside the penny-pinching, says Mr Suzuki. Consumers are showing a willingness to spend more on products that provide greater value, such as rice balls made with higher quality ingredients or Ringer Hut's dishes that use only vegetables made in Japan. "Consumers and retailers alike are tired of falling prices. Consumers are getting tired of buying cheap things and retailers are getting tired of lowering prices," he says.

But, he adds, it is still too early to tell whether or not the trend will help fight deflation.

An industry finds a shiny new model

The city of Tsubame in Niigata prefecture was a thriving manufacturing base for cutlery, until cheaper imports from China, which is a key contributor to Japanese deflation, nearly wiped out the industry.

This in turn devastated Tsubame's metal polishers, with many Japanese cutlery makers moving production to China. The number of metal polishers in Tsubame fell from 1,428 in 1970 to 600.

What saved many of them was a shift to more value-added work. A group of 39 metal polishers and manufacturers joined forces as Migakiya Syndicate. Instead of polishing cutlery, Migakiya – which means "polisher" – applies its skills to products such as a finely polished stainless steel beer mugs costing as much as Y19,950 ($237). The mug is so popular that there is a two-year waiting list.

The group also polishes the wings of private jets, both in Japan and overseas.

The case study

How to deal with new competition

Adapt the business model constantly

The story. Research in Motion is a leading manufacturer of wireless devices. The Canadian company's breakthrough product was and continues to be the BlackBerry. However, the business faces a number of strategic challenges. RIM has seen its stock performance stagnate while rivals such as Apple and Google have performed strongly and started to erode its market dominance.

The challenge. A number of strategic shifts in the smartphone market have affected the company adversely.

First, Apple has fundamentally changed the sector with the launch of the iPhone. The device has established a dominant position, especially in the consumer segment, and is now making inroads in the corporate market that has traditionally been BlackBerry's dominant space. More recently, Apple has entered the tablet PC market with the iPad.

Second, the sharp growth in take-up of smartphones using Google's Android operating system is also eating into BlackBerry's market share.

These two challenges have had a double-whammy negative impact on RIM as both volume growth and margins have eroded with increased competition.

How is RIM responding. While some investors and analysts have called for a dramatic change in RIM's operations, others fear that the company will dilute its core competence by trying to compete with the iPhone and the Android platform.

Instead, RIM has taken a multipronged strategic approach. First, the company has strengthened its presence in the enterprise market by introducing a number of new BlackBerry models, many of which have improved touchscreens to make the user experience more akin to competitor devices. It has also trumpeted the data security of BlackBerrys, which offer heavily encrypted communications services.

Second, the company has made strides in getting its "App Store" off the ground. While it still lags behind the iPhone and Android app stores, it has reached a critical mass with more than 15,000 apps, which at least gives it a presence.

Finally, RIM is entering the tablet market with the expected launch of the PlayBook in early 2011.

Key lessons. First, the danger for any company with a blockbuster product is a sense of invulnerability. The BlackBerry has been a gold mine, given its dominance of the enterprise market for wireless technology. However, as the success of the iPhone and Android platforms have proved, this is not enough in the long term.

Second, companies must not just stick to their knitting – especially when everyone else learns how to knit. This is especially true in the technology industry, where the parameters of business change quickly and disrupters are constantly challenging established players.

RIM must learn to ma[illegible]its products not only effect[illegible] and powerful but appealing as well. For a long time, RIM relied on the assumption that companies would require employees to use the BlackBerry platform, an assumption that has weakened over time.

Third, companies need to consider all potential competitors. Both RIM and Apple are guilty of focusing too much on each other, and being slow to recognise the growing threat from the Android platform.

RIM will have to compete both with the style and finish of the iPhone, as well as the open-source driven flexibility and lower cost of Android.

The verdict. RIM's multi-pronged approach should help it prevent further declines in market share and consolidate its position.

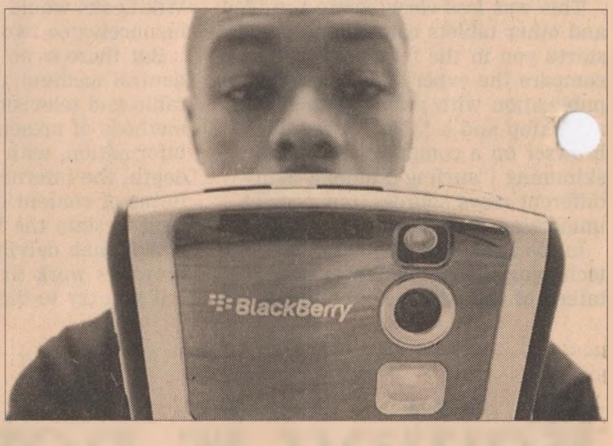
In recent years, avid BlackBerry users were tempted by the iPhone. Now, the BlackBerry line has all the multimedia functionality of the competitors, along with its core strength of security.

The company's recent marketing strategy showcasing the multimedia and social networking functionality of devices also suggests that RIM is serious about expanding its consumer market share.

Finally, RIM is making a serious attempt to enter the tablet market. While it is unlikely that the PlayBook will overtake the iPad in terms of volume sales, it could be the Apple's most credible challenger as it is aimed at RIM's core business users.

Partha Mohanram

The writer is the CGA Ontario professor of financial accounting at the Rotman School of Management, University of Toronto



The review

An early account of BP's history in the US does not have all the answers

Drowning in Oil

BP and the Reckless Pursuit of Profit

By Loren Steffy

McGraw-Hill, $27/£19.99

If journalism is the first draft of history, instant books are the second. The official US commission of inquiry into the Deepwater Horizon disaster is still a couple of months away from delivering its initial report, but already the first books on the world's largest offshore oil spill are hitting the shelves.

As the business columnist for the Houston Chronicle, and a BP-watcher since the Texas City refinery explosion of 2005, Loren Steffy was in the right place to follow the oil spill close up, and knows enough of the background to set it in the context of BP's troubled history in the US.

His strengths and weaknesses, however, are exactly the ones you would expect from a writer with his perspective. Steffy is very good on the drama of the accidents, and on the technical details of the hazardous business of offshore oil extraction. What he fails to do is get beneath the skin of BP, to anatomise the flaws in the company that lay behind the oil industry's worst disasters of the 21st century.

The basic facts, as Steffy sets them out, will be familiar to anyone who has followed the media this year. BP was built from a "staid and stodgy" formerly state-owned company into a world leader under Lord Browne who, Steffy observes, was "something of a rarity – a rock star of British business".

After taking over as chief executive in 1995, Lord Browne led BP into a series of daring takeovers, including Amoco and Arco in the US, and tripled the company's share price.

In a move that won him few friends elsewhere in the oil business, he embraced renewable energy and adopted the slogan "beyond petroleum". The company's name was changed from British Petroleum to BP (via, for a brief period, BP Amoco) and the logo evolved from a shield to the "helios", a sort of green and yellow sunflower.

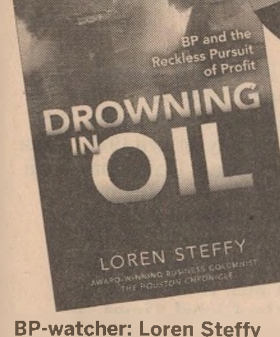
Awarded a peerage in 2001, Lord Browne was featured in Vanity Fair magazine and his home in Architectural Digest. Notoriously, he was dubbed the "Sun King" in an Financial Times profile, a tag which implied that even then there was some scepticism about his management style.

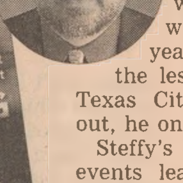
All the while, however, "warning signs were piling up", Steffy says. "Beneath the veneer of fawning media coverage, BP's oil operations, which generated most of the company's revenue but far fewer headlines, were beginning to fray."

The veneer was shattered in March 2005 by the Texas City disaster, which killed 15 people. It was that accident that drew Americans' attention to BP, a company that had until then been "little more than a logo on a Matchbox truck". As the full details of the explosion emerged, it became clear that BP's executives, up to and including Lord Browne, had failed to take a strong enough lead in insisting on safety at the refinery.

Other, less catastrophic, problems followed, including the partial flooding of the flagship Thunder Horse production platform in the Gulf of Mexico, allegations of market manipulation by oil and gas traders, and spills from corroded pipes in Alaska that forced the temporary shutdown of the pipeline system.

It is that litany of failures, and many smaller ones besides, that meant that, when the Deepwater Horizon rig exploded on April 20, killing 11 men, it seemed inevitable that it had been working under contract to BP.





BP-watcher: Loren Steffy puts the story in context

This came in spite of the promise of a fresh start from Tony Hayward, who took over from Lord Browne as chief executive in 2007. Hayward warned that it would take five years to implement the lessons learnt from Texas City. As it turned out, he only had three.

Steffy's account of the events leading up to and following the Deepwater Horizon explosion are the most dramatic but also the least satisfying part of the book. The narrative is gripping but key questions about what was going on behind the scenes, in the White House as well as at BP, are left unanswered.

The book also suffers from going to press while the US inquiry into the spill is throwing out revelations about what happened before and after the accident. Some factors that now seem to be relatively unimportant are stressed in the book, while others that now have moved to centre stage, such as the roles of other companies in drilling the Macondo well, including Transocean and Halliburton, are left out.

Above all, there is no convincing account of how BP has serially failed to live up to its ambition of delivering, in Mr Hayward's words, "safe and reliable operations".

Several underlying causes are suggested, in line with explanations offered by other commentators: the failure to integrate the US acquisitions properly; a decentralised "entrepreneurial culture"; press[illegible] from the top for cost [illegible] that militated against declared safety objectives; a slack and a corrupt regulatory regime. Steffy suggests that "Hayward, like Browne before him, was blind to the consequences of his actions because . . . neither chief executive ever stood amid the charred rubble and burned flesh of their own decisions".

It is a cheap shot, and factually incorrect; one of a handful of lapses into purple prose that mar what is generally a carefully and powerfully written story.

The question "what is wrong with BP?" is of vital importance to everyone who works for or invests in the company. It deserves a better answer.

Ed Crooks