



The Approach to Macroeconomic Management: How it Has Evolved

Per Jacobsson Foundation Lecture

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I am greatly honoured to have been summoned out of retirement to deliver this Per Jacobsson Lecture, and I am delighted to do so. Per Jacobsson was an outstanding international public servant. He joined the BIS from its beginning in 1931 as Head of the Monetary and Economic Department and played a massive role in laying the foundations of the outstanding international central banking organisation that it is today. He went on to become Managing Director and Chairman of the Executive Board of the IMF in 1956 until his death in 1963. It is very appropriate that we should commemorate his great contribution to the international economic and financial system through this series of lectures.

I'd like to begin my remarks this morning by reflecting upon my own experience of the truly fundamental changes that have occurred – in the UK, but from different starting points and to varying degrees around the world – in our whole approach to macroeconomic management over the course of my own 40-odd year career at the Bank of England. Against that background I will go on to discuss the recent turbulence in global financial markets and offer some thoughts on the implications for financial regulation looking ahead.

So let me begin with some reflections on our change of approach to macroeconomic management, and I'll start with the change in approach to the supply side of the economy, which is crucially important because it is our supply-side capacity that essentially determines the rate of growth of output, and employment, and of incomes, that we can hope to sustain over time.

I joined the Bank of England straight from Cambridge in the early 1960s. And quite soon afterwards, in 1964, I was sent to Moscow for the best part of a year to study the Soviet economic and financial system. I never knew what I'd done to deserve such punishment, but, in the event, it proved to be a seminal experience for me. It soon became apparent that the centrally planned and controlled Soviet system was not working very well. There was a disjunction between what the central planners decided should be produced and what consumers wanted to buy.

There was in fact a wonderful story doing the rounds in Moscow while I was there, about a nail-producing factory. As the year-end approached they were way behind their physical production target. So, in order to catch up, they produced a single, massive, and totally useless 10-ton nail! And they were even paid for producing that nail by Gosbank – the Soviet central bank – which, at that time was more of an accounting organisation than a financial institution.

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Now that story was probably apocryphal. But you only had to go into GUM, the retail store alongside Red Square, and see row upon row of empty shelves alongside row upon row of shelves packed with goods that no one wanted to buy overflowing into the aisles, to see that things were not working well.

Khrushchev was in power when I arrived in Moscow, and sought to introduce a form of profit motive to improve things. But he was removed from office soon after I arrived – though I had nothing to do with that, I promise you!

But it was when I returned to the UK that my Soviet experience really made an impact on me. I realised, for the first time, just how centrally controlled and managed we, too, were in the UK. I'd grown up in the environment, and I suppose I'd simply taken it for granted.

The role of the Bank of England at that time was largely to administer all kinds of direct controls over the financial system on behalf of the government. We really were the East End branch of the Treasury. We had foreign exchange controls. We had credit controls – telling the banks how much they could lend, the purposes they could lend for, and even the form in which they could lend. And we rationed access to the capital market through the equity queue, and so on.

But it didn't stop at the financial system. In the wider economy we had prices and incomes policies. We had state ownership of swathes of industry, with very powerful trade unions secure in the knowledge that their employer could not go bust. And we had marginal rates of income tax which at one point reached an unbelievable 98% on investment income.

Now virtually all of this has now happily gone. Over the next 30 years or so we moved, very gradually, at times imperceptibly, to a much more market-based system. Yes, of course, we still have all kinds of rules and regulations – as we must have in some degree – for economic reasons: markets must be reasonably fair as well as free if they are to perform their function of allocating resources effectively. But we also need rules and regulations for social reasons. Regulation can, and no doubt does in some respects, go over the top: it's often not obvious, as a matter of degree, where the balance is most effectively struck. But the difference, it seems to me, is that for the most part, the rules and regulations we have today – at least in relation to the financial and economic system – do not dictate what we can and cannot do. Rather they tell us what criteria we must meet, and what standards we must observe, in doing whatever it is we **choose** to do. And that leaves much more room for competition between producers, nationally and, to a large extent internationally, and much greater freedom of choice on the part of consumers. And that in turn engages the ideas and imagination, the energies and enthusiasms, of people at large within our society, rather than leaving everything to be determined at the centre.

This evolution of the approach to management of the supply side of the economy was not, of course, unique to the UK. In fact, as I say, it has occurred, from different starting points – with the move away from communism the extreme case – and to varying degrees – depending upon the pace of development of markets, especially financial markets, and lingering protectionism in some cases – but the general direction has been much the same across the world. And there is no doubt, to my mind, that it has had a positive effect on the supply side of our economies, which is – as I said at the outset – fundamentally important in terms of our productive potential.

But there have been equally fundamental changes – again gradually over time – in our approach to management of the **demand** side of the economy.

For years in the UK, fiscal and monetary policy were operated substantially in tandem – often accompanied by direct controls – with the broad objective of managing what was seen to be a trade-off between growth and employment on the one hand and inflation and the balance of payments on the other. If growth slowed and unemployment started to rise, both the fiscal and monetary policy levers were pushed forward to “go” together, until inflation, or the



balance of payments threatened to get out of hand. At that point the levers were both pulled back to “stop”. This go-stop approach to demand management tended to aggravate, rather than mitigate, the boom-bust economic cycle. And worse still, things were becoming explosive with inflation tending to become progressively higher from one peak to the next and unemployment higher from trough to trough.

We gradually learned from that experience. We learned that there really is no trade-off between growth and inflation, except possibly in the short term, but not necessarily even then, given the short-termism in economic decision-making that it engendered in the population at large.

We learned, too, that fiscal policy is in fact a cumbersome instrument for demand management, given the time it takes to put into effect; and we began to focus increasingly on the ratio of debt to GDP over the medium to longer term as a fiscal policy constraint.

And that left a more specific role for monetary policy – by now essentially the management of short-term interest rates – in our approach to overall demand management, with the objective, not of managing the earlier, perceived, short-run trade-off between growth and inflation, but of keeping overall, aggregate, demand growing consistently over time broadly in line with our underlying supply-side capacity to meet that demand. We came to terms in fact with what has become the near-universal central bankers’ mantra that “Stability is a necessary condition for **sustainable** growth”. I used to chant this out loud three times each night before going to bed! You may care to join me in chanting it out loud now! ... Perhaps not!

In pursuit of that objective we tried a number of different approaches in the UK – a variety of different money supply targets, unfettered discretion, and exchange rate targeting – until, in 1992, market pressures forced us out of the European Exchange Rate Mechanism, at which point we adopted a low and stable, and symmetrical, target for retail price inflation, set by Government, not simply as an end in itself, but as a measure – or a barometer if you like – of stability in the wider sense of the balance between aggregate demand and the underlying supply-side capacity of the economy to meet that demand that I mentioned a moment ago. Soon afterwards we moved to much greater transparency – and public accountability – of the monetary policy decision-making process, through the publication of the minutes of the meetings which I and my senior colleagues had with the Chancellor of the Exchequer who still then took the decisions about interest rates. And that led on, some five years later, in the summer of 1997, to operational independence for the Bank of England in the setting of interest rates – and the creation of the Monetary Policy Committee. The Chancellor still sets the low, symmetrical, inflation target; and the Bank remains publicly accountable for achieving it.

Now, the critically important thing to understand is that all of these really fundamental changes in approach, to the management of both the supply and the demand side of the economy, came about very gradually over time as a result of an emerging consensus across a broad part of the political spectrum in the UK. It was like a very complicated jigsaw puzzle gradually being put together. Operational independence for the Bank of England was for me the last piece of the jigsaw puzzle, and I would have been less comfortable if it had been introduced **before** the other pieces were in place because it would very probably have given rise to tensions between the Government and the Bank of England if the political consensus was incomplete.

And things worked out pretty well for us in the UK over the past 15 years or so – with consistent quarter-by-quarter growth at an average annual rate of around 2¾%, with a consistent rise in employment to an all time high, and a fall in unemployment to a more than 30-year low; and with inflation consistently low and relatively stable. And that’s despite the Asia crisis in the 1990s and the mild recession in many other industrial countries in the early years of the present decade.



Only a year or so ago, the world economy as a whole was looking in pretty good shape. GDP growth – led by the US, but also by some of the emerging markets, notably China and India, had recovered to around 5% a year – which was higher than for over 30 years. Inflation was still reasonably low, though it had begun to pick up on the back of rising energy, food and commodity prices. And while there were some other dark clouds on the horizon, as there invariably are – notably persistent global and domestic imbalances – they did not seem to be immediately particularly threatening.

But then, of course, we were hit by the sudden storm in global financial markets last summer, which has proved to be a very stark reminder that economic and financial stability go hand in hand: like love and marriage you can't have one without the other.

With the benefit of hindsight, of course, we should all have seen the storm coming.

In the face of the economic slowdown in the industrial world in the early years of the decade – when inflation generally was under control – official interest rates more or less everywhere were reduced to abnormally low levels. Nominal rates were around zero for much of the time in Japan; and they troughed at 1% in the US, 2% in the eurozone; and 3½% in the UK – and that already gave rise to potential social, as well as economic, concerns in some countries relating to a rapid rise in household debt and escalating house prices. I know that we were very conscious of this internal imbalance in the UK at the time, and tried hard not to do more than we had to do to keep the economy moving forward even though inflation was somewhat below our symmetrical inflation target for some of that time. But what I think we failed to anticipate were the wider financial market consequences of what came to be called “the search for yield”.

There were two sides to the equation. Those with money to invest – insurance companies, pension funds, hedge funds and so on – showed an increasing appetite for marketable debt assets yielding higher returns. And that provided an incentive for other financial intermediaries – notably banks – to increase their earnings through fees on loan origination which might initially be held on their balance sheets – funded by borrowing in the wholesale money markets, but which were also sold down into the marketplace on a very large scale. And the banks were certainly not at all slow to respond to that incentive!

Over the past five years, since I retired, the intense competition and technical innovation in loan origination and distribution through marketable debt instruments has resulted in an entirely new – and predominantly acronymic – language! I was aware of “subprime” lending – though not the potential scale of it – before I left the Bank and familiar with some expressions like “cov-lite”. I understood the principle of “securitisation”. But CDOs, CLOs, ABSs, ABCP and SIVs, not to mention CDSs and “monoline insurance” were all still very much in their infancy. And I find it difficult to understand the highly sophisticated slicing of debt into different tranches of risk – or how they are related – particularly when they include market trigger points in addition to the default risk on the underlying assets. I don't understand how they are related – or even rated. I may not be alone in that!

Among the consequences of all this was a dramatic increase in leverage on financial transactions more generally. And there was also a sharp and progressive narrowing of spreads between higher and lower risk debt instruments until last summer in what can clearly now be seen as a widespread mispricing of risk.

Now I'm not suggesting that the financial world went completely mad. The new instruments and techniques will no doubt have contributed to economic activity, at least in the short term. And, in principle, the spreading of risk right across the financial system, nationally and internationally, ought to mean that while defaults on debt instruments will certainly continue to occur – and that's inherent in a market-based system – which could impose losses, or even bring down, individual financial institutions, it ought to mean there is actually less risk of a systemic crisis. But that of course is not what we've seen since last summer.



An important part of the explanation – it seems to me – is that the scale and form of debt origination, and its distribution across the global financial services industry, have made it impossible for anyone – whether regulators or market participants – to quantify the aggregate amount of debt outstanding within the system or to know just where the debt is being held.

Now, many market commentators and regulators and central banks – including certainly the FSA and Bank of England, and also international organisations like the BIS and IMF – had expressed unease about “the search for yield” and narrowing of spreads for some time before last summer. But no-one, anywhere, to my knowledge, ever anticipated the dramatic events that we saw last summer.

As it was, the surprising revelation of substantial US subprime losses in two relatively small European banks prompted a frantic reconsideration – across the financial system everywhere – of the possible scale of outstanding debt and where it might be held. The almost instant reaction was a wholly unprecedented freezing up of the markets in securitised debt instruments and in the wholesale money markets in the major industrial countries. Even banks that in fact had ample liquidity were reluctant to lend – certainly for more than a few days – because they did not know the extent of the exposure of potential borrowers or how much debt, that they themselves had originated very often, they themselves might have to retain, or take back on to their own books. Many banks faced the prospect of massive writedowns in their financial accounts as the price of their holdings – not just of US subprime debt but marketable debt instruments more generally – plummeted, if indeed a market price could be identified at all.

Happily the major central banks have succeeded in calming things down somewhat in the wholesale markets – making very large amounts of liquidity available, to a wider range of counterparties, for longer periods, against a wider range of collateral, and at less penal interest rates. It’s too soon to say that the systemic liquidity crisis is over – there may well be further alarms and excursions as we progress through the rest of the year. But, as I see it, the central banks are very much on the job and have things under reasonable control.

Many banks and other institutions have, as I say, had to make massive provisions and to raise very large amount of equity, which have had a very negative impact on their share prices. Some senior executives have lost their jobs. It’s been a very tough time.

But the only real calamity in the UK has been the sad case of Northern Rock – which was an extreme case of reliance for liquidity on the wholesale debt and money markets.

The debate about Northern Rock will no doubt continue to rumble on. I find it ironic that retail depositors only began to queue outside the Northern Rock branches wanting their money back *after* the Bank of England had announced massive liquidity support, when the depositors’ money was safer than it had been for weeks.

The FSA, some say, should have seen the problem looming, and the FSA itself has accepted that its supervision was not all that it might have been. But, frankly, as I said earlier, I don’t know of anyone who saw the sudden freezing up of the wholesale markets coming as it did, and I don’t see how one can expect the regulator to foresee what happened when the financial managers operating in the marketplace didn’t. Regulators set minimum standards to reduce the risk of financial institutions getting into trouble. But they don’t actually run the financial institutions or guarantee that they cannot fail. There is a real danger that the financial system would be throttled if that were what was expected of the regulators.

Others say that the problem could have been avoided if the Bank of England had acted more promptly – and more discreetly – than it did in granting Northern Rock the liquidity facility it needed. But, given the scale of support that was needed, that seems wholly unrealistic to me. And if the thought is that the Bank – or the Treasury – should have acted to save Northern Rock as an independent entity, rather than to limit the damage caused by its predicament to the financial system as a whole, that, to my mind would have set a highly



dangerous precedent, in terms of moral hazard. The “uncomfortable fact” – or what Al Gore might call the “inconvenient truth” – is that the buck stops essentially with management and shareholders. That may sound hard-hearted. But if we move away from that, we will revert to the days when the authorities were directly controlling the financial system as a whole – back to the days of direct controls – which would certainly not be in our overall economic interest.

But I see no point in the “blame game”. There are, certainly, important *lessons* to be learned from all of this. As far as the authorities – nationally and across the wider international financial community – are concerned, I’ve already touched upon the need for greater transparency in our increasingly sophisticated and integrated financial system. That may well involve greater coordination between regulators of different parts of the financial services industry in some countries, and greater cross-border coordination and exchange of information between them. The approach to liquidity risk management, in particular, clearly also needs to be reconsidered. Regulators do, of course, already set minimum liquidity standards, typically requiring banks to hold sufficient liquidity to meet potential liabilities for a period ahead. But, in measuring that liquidity, so-called “marketable assets” are often regarded as immediately available cash, the assumption being that cash would always be available to banks wishing to sell or borrow against those assets. That clearly needs to be reconsidered. The depositor protection regime also needs to be reviewed. There may well be a case – on social as well as financial stability grounds – for increasing the size of the deposits protected, and perhaps also for accelerating the compensation process. But there would be a point at which depositors would simply place their deposits with whoever offered the highest rate of interest – with more prudent depositors effectively left to pick up the tab in the event of a failure elsewhere.

The debate on all of these issues – and others – thrown up by the crisis is already under way, both at the national level and within the relevant international organisations. In the UK we’ve had consultation documents from both the FSA and the Treasury inviting comments from markets, and I gather the Basel Committee is discussing liquidity standards, for example. It will be important that we do not rush to over-hasty conclusions on all of this, because there is no doubt that the financial world itself out there will be changing.

I will always remember the very different – and also very sad – case of Barings, brought down by a rogue trader in Singapore. I recall, in particular, that for months afterwards senior bankers from around the world said to me “Eddie, there but for the grace of God go I”. And they had sent off auditors and inspectors to their branches and subsidiaries to ensure that they had effective controls in place, and that the controls were being properly observed, so that they could rely upon the figures reported to them, whether profits or losses. It did more good, in terms of the financial system as a whole – at least for a time – than anything the authorities could themselves have done. And ugly and painful as events since last summer have been – and may well continue to be for a while – I have no doubt that the market itself will be looking at the lessons to be learned for their own businesses.

The big question now, of course, is what impact will the financial turbulence have upon the future evolution of the macroeconomy? What will be the knock-on effects?

I don’t pretend to know the answer to that question with any great confidence – and to be honest I sometimes wonder whether people who think they *do* know the answer really understand the question!

There’s no doubt the financial developments I’ve discussed – which are clearly producing a pronounced, and necessary, repricing of risk, with a tightening of credit, notably to the household sector, but also more generally in terms of leverage – will contribute to a slowdown in the rate of growth of demand. Up to a point that is not necessarily a bad thing in that it should contribute to reducing the external and domestic imbalances we’ve lived with for some time. The question, as always, is a question of degree. Will it mean an absolute



decline in demand – and negative growth at least for a while in some countries – or will the slowdown be more modest?

Perhaps it's because I'm retired, but I'm reasonably hopeful that with the central banks now more on top of the liquidity problem, and with repricing of risk clearly now under way, and with many of the banks most severely affected by losses and writedowns having moved aggressively – and very successfully in many cases – to raise new equity, the financial storm will gradually blow itself out. But it will probably take a while before markets generally accept that this is in fact happening.

In the meantime the major industrial countries face a macroeconomic policy dilemma. The slowdown in demand associated with financial turbulence is currently being compounded by the increase in inflation stemming from the rise in world oil and energy, food and commodity prices. As demand growth slows, so too should these inflationary pressures; but that clearly will take time. We need to hold on to the fact that it is the pace of change in the level of prices that determines the rate of inflation. Even so the slowdown in inflation will clearly take time. Meanwhile, inflation is likely to remain well above target in the UK and the eurozone, and higher than I'm sure they would wish to see in the US. And that carries the risk that inflationary expectations, which have generally been subdued in recent years, may escalate affecting economic behaviour.

Maintaining stability – in the broad sense of balance between overall demand and supply-side capacity to meet that demand – will not be easy over the next year or two. But I'm reasonably optimistic – which is strong language for a central banker, even a retired central banker – that it will be achieved looking further ahead. And I say that because I am convinced that the broad political consensus on the overall approach to macroeconomic management which I described at the beginning of my remarks, remains very much intact.

It is in that context that I have no doubt that the authorities will pay very close attention to all the emerging economic and financial evidence, and that their policy decisions will be both measured and carefully considered.

We will in my view, get back on track over the next two or three years, but it won't be an easy ride.

Thank you for your attention.