

Questionnaire in advance of Treasury Committee hearing

Adam Posen

A. PERSONAL AND PROFESSIONAL BACKGROUND

1. *Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in carrying out your duties as a member of the MPC?*

No. I will continue my paid affiliation with the non-profit, non-partisan Peterson Institute for International Economics in the part-time when I am not at the Bank (see reply to Question 7 for details). I will continue my membership in various non-profit professional organizations, including Board membership at Bruegel (a similar research institute in Brussels) and as an adviser to the US Congressional Budget Office, both of which require fewer than four meetings a year. There is no conflict of these limited and research-oriented commitments with fulfilment of my duties as a member of the MPC.

2. *Do you intend to serve out the full term for which you have been appointed?*

Yes.

3. *Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the MPC? In particular, what areas of the MPC's work do you believe you will make a particular contribution to, and which will you have to undertake additional research into upon your arrival?*

For seventeen years, I have been conducting applied macroeconomic research, with my areas of expertise being monetary policy and central banking issues, fiscal stabilization policy, response to financial crises in advanced economies - including the critical case of Japan in the 1990s - and business cycle forecasting in advanced economies. For most of that period, 1997-present, I have been a senior fellow at the Peterson Institute for International Economics (PIIE), which is widely recognized as the leading think tank in the world on these and other international economic issues. During that time, I have published as author and/or editor five widely-cited and influential books, and more than thirty also widely-cited articles, on such topics as the impact of inflation targeting, macroeconomic stabilization and the trade-off with long-term debt accumulation, the sources and effects of central bank independence, the causes of Japan's lost decade of economic growth, how to resolve banking crises, and the relative status of the dollar and euro as reserve currencies - all highly relevant topics for the MPC's work. I have also been part of teams forecasting growth and inflation in the G7 economies, including the UK, but primarily Germany, Japan, and the US, for most of the time since 1994.

I have also worked directly inside and with central banks, initially as an economist at the Federal Reserve Bank of New York from 1994-1997, where I advised the Bank's President and top management on the G8 economic forecast, the costs of disinflation, and the widespread adoption of inflation targeting. While there, I conducted foundational research on the inflation targeting monetary framework as implemented in the United Kingdom and elsewhere, jointly with now Federal Reserve Chairman Ben Bernanke and former Federal Reserve Governor Frederic Mishkin. I spent the first seven months of 2006 as a Houbton-Norman Senior Fellow at the Bank of England, housed in the structural analysis division, and contributed to the research and forecasting of the Bank, particularly on the international side and on the understanding of the low inflation environment. I also completed research on the anchoring of inflation expectations and wage pass-through, comparing across a range of advanced economies.

I have consulted for central banks and other economic policymakers on a part-time basis regularly between 1997 and the present. Engagements with central banks have included advising the European Central Bank on their response to euroisation (the unilateral adoption of the euro) in eastern Europe, the Federal Reserve Board on lessons from Japan's lost decade for monetary and financial policy, the Deutsche Bundesbank on how differences in banking systems affect monetary policy transmission, and the Reserve Bank of Australia on the proper response of monetary policy to asset price bubbles. I have also advised the UK Cabinet Office in the run-up to this year's London G20 summit, the US Treasury and Council of Economic Advisers (under both Clinton and Bush) on the crisis in Japan and how to encourage reform there, the IMF recurrently on fiscal policy responses to crises and on banking system problems in Europe, the US, and Japan, and a range of short-term projects for other governments on the structure of monetary policymaking. I was recently re-appointed to a second two-year term as a member of the Panel of Advisers to the Congressional Budget Office, where I engage with the CBO Director and professional staff on the interaction between short-term policies and longer-term fiscal balance, inflation, and growth potential.

I hope to contribute to the work of the MPC as a good working colleague and independent voice, in the full spirit of the External Member role. In terms of special expertise that I bring, there are three areas. First, I hope that my extensive knowledge of the Japanese crisis of the 1990s, as well as of the US Savings and Loan crisis of the 1980s and of the Swedish banking crisis of the early 1990s will assist in avoiding many of the policy mistakes made in situations with some similarities to today's environment (which to the Bank's credit have been avoided so far). Second, I hope that my ongoing empirical research and critical re-evaluation of inflation targeting as it has evolved and proven out in various countries, including the UK, will contribute to any discussions of how to adapt the Bank's regime and practices during the three years of my appointment. Third, I believe my deep knowledge of the US, Euro Area, and Japanese economies will enhance and improve the MPC's understanding of the global context in which UK monetary policy operates, and how developments abroad may affect the UK economy.

There are three areas of primary concern for me in terms of my research, which I intend to pursue upon my arrival at the Bank.

- First, I will undertake an independent evaluation of the potential growth rate in the UK going forward after the crisis. It was a troubling puzzle for many economists, myself included, why the UK did not show greater productivity growth during the NICE years

and financial boom of the preceding decade, and understanding the sources of that shortfall will importantly inform the MPC about the prospects for sustainable growth of the UK economy going forward. My prior cross-national work on the determinants of potential growth and the impact of financial crises on that trend will inform this research (I will also make sure that I am fully up to speed on current developments in the UK economy - please see my detailed response to question 11 below).

- Second, I am re-examining very closely the early years of Japan's lost decade in strict comparison with developments in the UK, US, and Germany over the last two years. In particular, I am focusing on the impact of unconventional monetary policy measures, the long-term interest rate response to fiscal stimulus, and the inflation expectations response to both. I am working on this project jointly with the noted macro-econometrician Kenneth Kuttner, and am committed to producing a paper with our initial results for the upcoming issue of the *Oxford Review of Economic Policy*.
- Third, I will begin research on the three-dimensional exit strategy that all central banks and governments in the OECD, including critically the UK, must undertake from their emergency policy measures when the crisis is past. I say "three-dimensional" because exit will require the removal of monetary ease and liquidity, the reversal of fiscal stimulus and deficits, and the withdrawal of guarantees for, and some public ownership of, the financial sector. The timing of each on its own terms, with what practical indicators policymakers should watch, is of vital importance, as is the sequencing of the exit in each of the three areas when they will interact. Also important is the international coordination of efforts, or at least prevention of destabilizing competition, in the financial sector exit and to a lesser degree the exchange rate impact of monetary policy. Fiscal policy remains a national matter in impact as well as governance, though there are also some empirical issues regarding the sizable issuance of public debt by several states simultaneously.

4. Which of your publications or papers are of most relevance to your future work on the MPC?

On inflation targeting in practice:

"The Future of Inflation Targeting," *Challenge*, 51(4), July-August 2008, pp. 5 - 22

"Six Practical Views of Central Bank Transparency," in Paul Mizen, ed., *Central Banking, Monetary Theory and Practice: Essays in Honour of Charles Goodhart*, Vol. 1, Edward Elgar, 2003, pp. 153-172

Inflation Targeting: Lessons from the International Experience, with Ben Bernanke, Frederic Mishkin, and Thomas Laubach, Princeton University Press, 1999

"Disciplined Discretion: Monetary Targeting in Germany and Switzerland," with Thomas Laubach, *Princeton Essays in International Finance*, No. 206, December 1997

On lessons from Japan's lost decade:

"Frog in a Pot: Germany's Descent into the Japan Syndrome," *The National Interest*, Spring 2003, pp. 105-118 (longer version with data analysis, "Is Germany Turning Japanese?," IIE Working Paper No. 03-5)

"Fiscal Policy Effectiveness in Japan," with Kenneth Kuttner, *Journal of the Japanese and International Economies*, December 2002, pp. 536-558

“The Great Recession: Lessons for Macroeconomic Policymakers from Japan,” with Kenneth Kuttner, *Brookings Papers on Economic Activity*, 2001:2, pp. 93-185

“The Political Economy of Deflationary Monetary Policy,” in Ryoichi Mikitani and Adam S. Posen, eds., *Japan’s Financial Crisis and its Parallels with U.S. Experience*, IIE, 2000, pp. 1-26

Restoring Japan’s Economic Growth, IIE, 1998

On resolution of financial crises and dealing with bubbles:

“A Proven Framework to End the US Banking Crisis Including Some Temporary Nationalizations,” Testimony Before the Joint Economic Committee of the US Congress, Hearing on “Restoring the Economy: Strategies for Short-term and Long-term Change,” February 26, 2009

“Why Central Banks Should Not Burst Bubbles,” *International Finance*, Winter 2006

“It Takes More Than a Bubble to Become Japan,” in Anthony Richards, ed., *Asset Prices and Monetary Policy*, Reserve Bank of Australia, 2003, pp. 203-249

Japan’s Financial Crisis and Its Parallels to U.S. Experience, co-editor with Ryoichi Mikitani and contributing author, IIE, 2000

On assessing potential output growth during times of change:

“Has EMU had any impact on the degree of wage restraint?”, with Daniel Popov Gould, in David Cobham, ed., *The Travails of the Eurozone*, Palgrave, 2007

“The Difficulty of Discerning What’s Too Tight: Taylor Rules and Japanese Monetary Policy,” with Kenneth Kuttner, *North American Journal of Economics and Finance*, March 2004, pp. 53-74

“Unchanging Innovation and Changing National Economic Performance in Japan,” in Richard Nelson, Benn Steil, and David Victor, eds., *Technological Innovation and Economic Performance*, Princeton University Press, 2002, pp. 74-111

“Recognizing Japan’s Rising Potential Growth,” *NIRA Review*, Winter 2001, 8(1), pp. 48-53

B. ACCOUNTABILITY

5. *If you were to make yourself available for reappointment to the MPC at the end of your term, what criteria should be used to assess your individual record as an MPC member?*

The primary contribution an External Member of the MPC can make to Bank of England policymaking is to promote better decisions by the MPC, both by preventing mistakes through challenges to received wisdom and by raising issues or perspectives that are new and useful (not different just for the sake of being different). Successful policy decisions are those that keep inflation close to target over the set medium-term horizon, while ameliorating shorter-term economic shocks to employment and to financial stability. A second priority is to make those decisions and the reasoning for them more comprehensible and credible to markets and to the British public. For each of these potential contributions, the critical performance factor is the ability to be persuasive on the basis of sound reasoning and objective data analysis.

Thus, if I were to make myself available for reappointment to the MPC in three years' time, I would suggest the following criteria would be relevant to assess my performance:

- Has the MPC made broadly the right decisions on monetary policy and related issues, given the information available at the time of decision? If not, was I on record as raising questions and alternatives to some of what proved to be the less successful decisions?
- Did my contributions to MPC discussions based on my previously established areas of expertise – policy options in the aftermath of financial crises; knowledge of major economies whose developments have substantial effects on the British economy; the practice of inflation targeting and central bank transparency issues around the world - lead to approaches and interpretations by the MPC that would otherwise not have arisen?
- When I did express a significant policy or forecast view that was either new or contrary to the majority of MPC opinion, was I successful in persuading other MPC members to my position, or was I able to elicit better arguments from the other members of the committee (or Bank staff) that persuaded me to change my position?
- Were there applied research projects, either conducted by me in the External MPC unit or encouraged by me among the Bank staff, which led to better informed decisions?
- Was I in demand among the general public, the press, market participants, and other UK government officials and stakeholders as a source of credible explanations for Bank policy and of the UK economic situation? Was this demand based on my constructive and forthright communication, but not due to any tendency to 'make news' just for the sake of making news or through undisciplined speaking?
- Have I contributed to the state of public discussion and understanding of economic policy issues in the UK more broadly?

6. *Do you believe there is merit in having an individual paragraph in the minutes of MPC decisions in which to explain your most recent vote?*

The transparency of MPC discussions, and the ability of individual members, including external members, to express their views in a timely manner, is one of the great virtues of the Bank of England's regime. It is also one of the great attractions of the position of External Member of the MPC. I do not see any urgency to change the current transparency measures regarding the minutes, which my research leads me to believe are the state of the art in central banking. But there is always room for improvement, and I will be in a better position to judge that upon having actually participated in at least a few monthly MPC meetings and one *Inflation Report* cycle.

In terms of this specific proposal regarding individual paragraphs to explain the most recent vote, there is a trade-off to consider. Making sure that every individual member is clear in their reasoning on the record, and thus accountable, is a worthwhile endeavour. Preventing members from hiding their views or their views being lost could be worthwhile as well, if there has been an issue of that recurring (but I am not aware of any such obscurity). On the other side, however, the more formalized and explicitly formatted the minutes, the less discussion will be free amongst MPC members – there will be a tendency at the margin for members to be more self-conscious about their statements, and in fact to write up or at least plan their remarks in advance. This to me could lead to less-than-optimal consideration of policy options and of the forecast, since the point of MPC meetings as I understand them should be to have engaged and open discussion. So my instinct would be against further specifying how the minutes should be

structured, and I expect that members of this Committee will have no difficulty finding the reasoning for my votes. But, again, I will be open to reconsidering this and related issues upon having more experience.

C. OTHER PROFESSIONAL ACTIVITIES

7. What other professional activities do you expect to continue/ undertake in addition to your position on the MPC and how do you intend reconciling these activities with your position as a MPC member?

My only ongoing employment outside of the Bank during my tenure on the MPC will be part-time work for the non-profit, non-partisan, Peterson Institute for International Economics [PIIE]. I will be a non-resident Senior Fellow, since I will be living in the UK for at least the duration of my MPC appointment. This is analogous to continuing an academic appointment, were I a professor. I will publish all my non-UK economy related writings and research with my PIIE affiliation, post them on the PIIE website, and where appropriate (say when I complete a monograph on the exit strategy) publish PIIE books. My affiliation with PIIE will be on a fixed part-time salary without benefits. There is no issue of reconciliation between this work and my activities as an MPC member.

I will also continue to write op-eds, newspaper columns, and magazine articles on economic issues. I will not comment directly on UK economic policy, let alone Bank decisions, in these writings. These are paid fixed-sum per article.

I will retain my membership of the Panel of Economic Advisers to the US Congressional Budget Office, and of the Board of Directors of the think tank Bruegel. These pay a nominal per diem and/or travel expenses for meetings. The CBO panel meets twice a year, and the Bruegel board four times, so the time commitment is small. These have no conflict to reconcile with my MPC duties, and in fact should assist me in better carrying out those duties by increasing my contacts with informed parties holding strong points of view and with new analyses.

8. Outside of MPC meetings, what activities do you intend undertaking in order to add to the public's understanding of the role and decisions of the MPC?

Communication with the general public by central banks is crucial. I have been a strong proponent of central banks committing to such efforts in my policy writing. I also believe in it strongly as a personal matter, having committed PIIE to outreach to the broader public during my tenure there as Deputy Director, and led by example, visiting a number of communities outside of the Boston-New York-Washington corridor for presentations and exchanges.

Thus, I intend to work actively with the Bank's Agents, the Bank's Press Office, and its other regional efforts, to be out around the United Kingdom for exchange of views with local people and answer questions. I also intend to engage in dialog with the public through my writing for the press, and to continue to give presentations of lectures and seminars, appear on public affairs panels, and the like, insofar as consistent with the time demands of my other MPC duties and the restrictions on appearances around MPC meetings.

D. MONETARY AND ECONOMIC POLICY

9. How might the system of control over monetary policy in the UK be improved? Is the framework of an explicit symmetrical inflation target the best within which to conduct policy? Has the MPC been given an appropriate inflation target?

The accountability structure of the Bank of England, having instrument independence to set interest rates in pursuit of a publicly announced price stability goal defined – and subject to reset – by Parliament, with a formal reporting process and disclosure by the minutes as well as the various *Reports*, is to my mind the right one for monetary policy. There are significant issues regarding the governance of the Bank with respect to financial regulation and supervision, which affects monetary policy, and which is obviously under current discussion by this Parliament and British experts. The governance of central banks' activities in financial stability has proven challenging to any number of central banks, and I am on record criticizing the Federal Reserve's failures on this account in recent years in particular (nor am I alone in offering that criticism).

It is important to recognize, though, that those failures on the financial stability side were not the result of inflation targeting or of central bank independence. The rise of the bubbles in the UK and elsewhere were driven by a combination of regulatory and supervisory failures with structural factors not entirely under UK policymakers' control. In fact, the continued anchoring of inflation expectations above zero under the current circumstances, without tipping either into deflation or being pressured upwards by temporary large public deficits, represents a triumph of the inflation targeting regime of the Bank of England. Both the direct economic outcomes of the current crisis would have been worse, and the ability to respond with macroeconomic stimulus would have been far more limited, had this system of control over UK monetary policy not been in place.

Regarding the explicit symmetrical structure of the target, there remains reason to think that undershooting a 2% inflation target has somewhat greater costs and risks to real economic output and employment than overshooting it by the same amount (Japan's deflation had bad consequences, but it must be noted was not as harmful as some of us, myself included, expected it to be). Along with the well-established upward measurement bias in inflation indices, this suggests greater activism in response to any sustained undershooting of the target. It seems as though the Bank is already on this path.

The key to any adjustments is to retain the target's ability to anchor inflation expectations, so any change to asymmetry must come as clearly justifiable on its own terms rather than as a stealth attempt to ease policy. The economic growth literature suggests that the costs of inflation only become significant once annual inflation gets up to the 8-10% level (so long as inflation is above zero). By the same token, there are no long-term growth advantages either to having 6% or even 4% inflation instead of 2%, and because the risks to the Bank's monetary policy credibility and thus of increased inflation volatility and higher long-term interest rates on UK government bonds are higher at higher levels of inflation, there is good reason why the Bank and other inflation targeting central banks mostly have targets of 2%. There are also good reasons of political economy and communication, as well as economic logic, to have the target be defined over broad headline inflation as opposed to core, as the Bank now does.

10. What lessons can be learnt from the recent economic history of Japan about the situation currently faced by the UK?

The first lesson is that Japan did not have to lose the decade of the 1990s the way it did. What the UK government and the Bank of England are now doing, in broad terms, is right. Policy activism to support the economy is the right response. I firmly believe that Japan would have recovered in 1995 had there not been bad fiscal and monetary policies and neglect of the banking system. I firmly believe Japan could have still recovered in 1998, had there not been neglect of the banking system and then premature tightening by the Bank of Japan with great uncertainty about future monetary policy. And, Japan did eventually recover in 2002 when the right policy measures were undertaken by the government and by the Bank of Japan. The bias towards macroeconomic policy activism, while it does have its costs, is the right one.

The second lesson is the question of spending money on stimulus versus spending money on recapitalizing the banks. If you take a broader historical perspective, it is clear that hesitation to finally fix their banks is a key part of what kept Japan from doing the right thing throughout the 1990s. The Japanese government did put money into cleaning up the *Jusen* (failed mortgage lenders tied to the banks) to some degree after the bubble. The Japanese government did put money, during 1997 and 1998, into dealing with a few failed institutions. Yet, even Japan's bank recapitalization plan of 1999 was a failure, as well, in the sense that it was too much of a giveaway to the banks with too little conditionality, even though it was well-intended. It was only after the measures taken by the Japanese government in 2002 with aggressive forced inspections and write-downs at the banks, that the market and IMF assessments of the bad loan situation matched the official government assessments. The UK seems to be well ahead of the US and most Euro Area governments in this area of providing banks capital and disclosing their real situation.

The third lesson I would take, something that was very actively demonstrated, repeatedly, in Japan, is that fiscal stimulus works, but only so far. If you engage in fiscal stimulus, you do get a multiplier greater than one. And even if you engage in wasteful fiscal stimulus -- bridges in northern Hokkaido Island that get 10 cars a day, it still has a positive multiplier. Such spending may not be a good idea long-term and, all else being equal, you might want to do things that have longer term benefits -- infrastructure investment, I think, has a good case here. Government spending or tax cuts do buy you growth in the short-run., and do prevent unemployment from rising more than it otherwise would. The idea is to smooth the growth during the downturn by borrowing against future income.

The key point, though, is that little if any fiscal spending or tax cuts generate sustainable growth without continued expenditure. And I mean that in two senses. First, as Japan demonstrated, you cannot move 13 percent of your workforce into construction in an advanced economy. It's not a good idea. Second, and more importantly, if you do not fix the banking system by the time your stimulus runs out, then private demand will not pick up when the stimulus runs out. That's what we saw in Japan in 1997, and that is what we saw in Japan in 1999-2000. So we have a clock ticking here in the UK as in the US and the Euro Area.

The fourth lesson concerns monetary policy and deflation. One of the striking facts to emerge is how inertial, how sticky, deflation was in Japan. Once deflation started, it went down to a negative-one percent roughly annualized rate, depending on which index you look at. But the bottom line was it never accelerated. Even when the economy stayed bad, it didn't start going to minus-2, minus-4 -- which a straightforward Phillips Curve model that has continued to predict pretty well on upside moves on inflation using output gap in Japan would have predicted.

This fact has a few implications. The first is that monetary policy did not remove deflation quickly in any easy way. Second, it meant that deflation though harmful was actually less destructive than some of us worried it might be. And third, we simply do not understand deflation very well. Whatever type of standard macro model one uses for analysis, you will find it difficult to generate this result.

In terms of monetary policy, I think these facts call for some degree of humility. The Bank of England is right to be engaged in quantitative easing to address our current problem. But I think we should stay away from very mechanistic monetarism that, "Oh, boy, they've printed a lot of money so at some point that has to turn into inflation." Or, "If we do this specific amount of quantitative easing, so it will lead to this result." Looking at Japan, it is clear that their quantitative easing measures had the right sign, in the sense of being stimulative, but did not have a predictable or even large short-term result, let alone cause high inflation.

Unconventional monetary policy measures that are largely directed towards alleviating concerns in specific markets have been very successful in freeing up those markets, whether by the Bank of Japan in the late 1990s, or by central banks today. The overall macro benefit of such measures however is more to prevent market disruptions than to positively stimulate the economy.

11. Do you consider yourself to be fully up to speed on the UK economic situation, and if not, how do you intend to rectify this?

I am not yet completely up on all aspects of the UK economic situation with the depth of detailed knowledge that I would like to have. I am rather familiar with the UK economic system, its long-term performance, and most aspects of the current situation, and in fact I have been following the UK economy professionally in my research and comparative policy analysis for two decades (since the time of my senior thesis on Thatcher's economic policies at Harvard College), so my knowledge gap should not be overstated. My direct experience as an economic forecaster and monetary policy advisor, and my time at the Bank in 2006, also leaves me well-qualified to hit the ground running as a member of the MPC. But the British public deserves to have MPC members with truly in depth knowledge of all aspects of the current economic situation, and who are familiar with the recent specific trends for all of the major data series, and I am not yet there.

I am committed to rectifying this deficiency. The steps I am taking include:

- Obviously, my starting place is to re-read all the MPC minutes, *Inflation Reports*, Governors' press conferences, and so on from the last several years. I have always read these in real-time, but I can profit from close re-reading. I will be following up on these with direct questions to the Bank's Deputy Governor Bean, Chief Economist Dale, and their staff – Charlie and Spencer have already offered every assistance in my studies.

- I am arranging to meet directly with most of the past External Members of the MPC since its creation (most of whom I already know), both to get their take on the current situation and on how best to contribute to the MPC from that position. Danny Blanchflower and Tim Besley both generously contacted me upon the announcement of my appointment, before I even got to reach them, and by meeting with each of them I will be getting quite differing views on the current forecast and situation to begin with.
- I am familiar with the main independent research institutions and university centres conducting research and making forecasts for the UK economy. Starting with the NIESR and Institute for Fiscal Studies, I will be asking for briefings from their teams, and getting to know their views and resources in more depth.
- I also am familiar with most of the City economists at the banks, investment houses, hedge funds, and advisory companies who work on the UK economic outlook and on fixed-income and monetary policy issues. I am in the process of setting up appointments with several of them, as well as reading their recent publications in these areas. I have also asked people I know who are active in the UK fixed income markets to suggest their contacts for meetings.
- I have numerous contacts with the excellent British civil servants of HM Treasury, the Department of Work and Pensions, the Cabinet Office, and other departments. I will also be arranging for briefings on their views, some of which they have already offered to me.

I am confident that this immersion and study, along with the benefits of the MPC meeting and associated briefings, will rapidly close the gaps in my knowledge of the UK economic situation. I successfully turned myself into one of the world's leading experts on first the German and then the Japanese economies, as well as on the economy of my home country, through undertaking similar study and networking programs. I have a very strong foundation of prior knowledge and of support both within and outside of the Bank on which to build.

12. What do you regard as the causes of the current economic crisis?

When considering the current crisis, we need to consider both whether there would have had to be some kind of financial-led contraction inevitably, and whether we had to have this particular crisis in its form and its severity. There is a long list of potential or plausible causes, running from the most specific and proximate to the broadest and longest term. So we can well imagine regarding this specific crisis, that if it was not for the nail of Lehman Brothers and AIG being mismanaged in September 2008, the shoe might not have fallen off, leading to the battle being lost. And surely the synchronized real estate booms of the UK, US, Spain, Ireland, and other places led to the specific pattern of losses in terms of regions and sectors that we have seen.

But I firmly do not believe that the whiplash of markets regarding bailouts last fall or even the real estate bust was the real cause of all our current problems. Six months before Lehman we had another investment bank go under named Bear Stearns, and everyone knew that Lehman was next. And of course the UK had its RBS, Northern Rock, and other specific financial failures prior to then, with less than optimal policy response in some of those cases as well. The financial market lock-up and near meltdown of September to December 2008 specifically could well be attributed to the creation of a panic at that time following Lehman and AIG. Yet, some form of

crisis seems to have been baked in for the UK, as well as for the US and most of the advanced economies.

There were two factors leading to the underlying crisis, in my opinion. First and foremost, central banks and financial regulators fell subject to an ideology of excessive faith in financial market actors. Policymakers around the world decided that financial firms could largely be left to self-regulate, that financial innovation was very, very valuable, and you didn't want to kill the golden goose with too heavy a precautionary hand, and that the ability of regulators and bank supervisors to do anything about the decisions of financial firms was extremely limited and likely to backfire. The US government and Federal Reserve played a key role in promoting this view worldwide in the 1990s and 2000s, and my profession of economists largely bought into it as well (with a few brave exceptions). But obviously there were those in the UK policymaking circles who shared this view, with the active advocacy of interests from the City in support of it, as well as the academic pressures.

I think it was a genuine mistake. I think the Clinton era economic officials, now back in government under Obama, and people at the world's major central banks believed in this ideology and they were wrong. They believed in it not for selfish, stupid reasons; they believed it because they genuinely thought it was right and logical. And there certainly were opportunists and corrupt people who took advantage of this ideological view, and there were certainly people with much broader, much simpler laissez-faire political ideologies who found this very convenient. But at its core there was, for want of a better word, elite opinion, that this is the way the world worked and that to me was the key factor. Policymaking is complicated. Mistakes are costly. So does that mean that our current crisis was inevitable? To a large degree, yes some form of financial-led contraction was inevitable, since the lack of regulation led to instability, and only the crisis itself proved the failure of this dominant approach to financial supervision and regulation.

Second, I think a number of economies were growing more quickly than was sustainable, given their domestic savings, and more obviously their asset prices were growing more quickly than commensurate with future growth rates of the economy. Ultimately, real estate prices have to correspond to growth in income and population, and corporate equity prices have to correspond to growth in profits, and while specific assets can keep growing in value for idiosyncratic reasons, the national averages for real estate prices and for stock prices are limited by growth in the overall economy. The lack of visible overall inflation was one part of why this was allowed to happen but really only a small part. This was allowed to happen more because the ideological faith in financial innovation led to overestimates of what would be the sustainable rate of growth, based on excessive belief in the rationality of the asset pricing mechanisms.

Even more importantly, the sources of this unsustainable growth in asset prices were things that policy did not have the instruments to address in the absence of greater financial regulation. To whatever degree international capital flows driven by high savings in China and the oil exporting countries led to international imbalances, and they contributed to the situation as well, there was no instrument available to deal with that either (raising interest rates attracts more rather than less capital inflow). So the proposals at present to add instruments to policymakers' toolkits to deal with financial imbalances are I believe productive, and should be coupled with rules that would force policymakers to utilize those tools.

07 July 2009