The conduct of economic policy

This year's Roy Bridge Memorial Lecture[1]—in memory of Roy Bridge who, as Assistant to the Governors, was responsible for the Bank's foreign exchange operations during the 1960s—was given by the former Chancellor of the Exchequer, Lord Lawson. In it, Lord Lawson addresses the question of what the main focus of attention should be in the conduct of economic policy. He seeks to show the dangers of a preoccupation with short-term movements in the business cycle. Economic policy cannot abolish these, and the suggestion that it can may result in an increased severity of cycles. And if too much attention is paid to cyclical developments, policy-makers may give too little concern to the areas where they can have an influence over prosperity in the longer term.

I am honoured to have been invited to deliver this year's Roy Bridge Memorial Lecture, in this splendid setting.

Although Roy Bridge never became an executive director of the Bank of England, let alone one of the Governors, he was a legend in his lifetime, as the greatest expert on the foreign exchange markets the Bank has ever had. Sadly, although he was in charge of the Bank's intervention and other foreign exchange operations during my time as a City Editor in the early 1960s, I never really got to know him—making the mistake of hob-nobbing with his superiors instead, who had rather less insight into these matters than he did.

Those were, of course, the years of Bretton Woods and fixed exchange rates, in which Bridge firmly believed, as he did more widely in the international financial co-operation which underpinned them—while occasionally chafing at the dangerously narrow margins within which he had to operate. I would not venture to guess where he would stand on these vexed questions today; but as a consummate operator and foreign exchange market tactician, I suspect that he would not have been greatly impressed by the handling of the events that led up to the ERM trauma of September 1992.

It is not, however, exchange rate policy that I wish to talk about this evening—partly because, within Europe at any rate, it has been displaced by the essentially political question of monetary union, and partly because there is a wider issue which I believe to be of more fundamental importance to the conduct of economic policy.

I would simply say that there are three basic propositions to which I believe Roy Bridge subscribed, which I would strongly endorse. First, the exchange rate is not merely a price like any other, about which the authorities can be blithely indifferent. It is far too powerful for that. So those responsible for the conduct of monetary policy are bound to take it into account. Second, no self-respecting country should tolerate a steadily-depreciating exchange rate. And third, co-operation on the exchange-rate front should form part of any properly-functioning system of international financial co-operation.

The more fundamental question I propose to address this evening, however, is what the conduct of economic policy ought to have as its principal focus of attention.

There can be little doubt that the question at the centre of the economic debate in this country at the present time is whether the substantial, but sadly necessary, tax increases due to come into force in a fortnight's time will kill—or at least severely maim—the recovery from the recession and, if so, what the Government should do about it. This is essentially a special case of the continuing obsession with the short-term progress of the economy, in which each new statistic that is published—many of which will subsequently be revised, in any case—is hailed as cause either for reassurance that the recovery is 'on course', or for concern that it is not.

It is hard to imagine a more futile focus of attention than this. In the first place, there is overwhelming practical evidence that economies—certainly, free economies—move in cycles. There are rival explanations of why this should be so, and rival theories of what—if anything—can be done about it. But the evidence of an—albeit irregular—cyclical pattern is painfully evident.

For Keynes, who was a close observer of, and active participant in, the financial markets, and whose thinking was greatly coloured by this, the cycle was essentially a matter of mood swings, from optimism to pessimism and back again *ad infinitum*—although this was made to sound rather more scientific by being described in the *General Theory* as fluctuations in the marginal efficiency of capital. The 'marginal efficiency of capital', however, was defined in terms of the expected return on new investment; and what fluctuated, Keynes explained, was expectations.

(1) Organised by the Forex Association, London and delivered in the Guildhall on 24 March.

Thus, to quote from the *General Theory*, in terms which describe with uncanny accuracy what occurred in the United Kingdom in the late 1980s:

> "A boom is a situation in which overoptimism triumphs over a rate of interest which, in a cooler light, would be seen to be excessive."

Sooner or later this overoptimism is shattered as it comes up against cold reality, leading to what Keynes describes as "disillusion", leading to "a contrary 'error of pessimism'". It was the problem of correcting this that particularly exercised him:

> "It is not so easy to revive the marginal efficiency of capital, determined, as it is, by the uncontrollable and disobedient psychology of the business world. It is the return of confidence, to speak in ordinary language, which is so insusceptible of control in an economy of individualistic capitalism."

Hence the need, as he saw it, for the government to step in with a programme of public works.

The Keynesians subsequently refined and complicated their master's analysis—to no great advantage. The essence remained a cycle which occurred as a result of the wayward behaviour of the private sector; and which, they claimed, could be stabilised not by monetary policy (that had been tried during the pre-Keynesian era; but, as Keynes had argued in the passages quoted above, did not work) but by an active countercyclical fiscal policy. Unfortunately, in the half century and more since the publication of the *General Theory*, the active use of fiscal policy has been demonstrated to be no more effective in eliminating the economic cycle than Keynes considered monetary policy to be. What it has done, however, is to leave many countries with a higher level of public spending, public deficits and public debt than they are comfortable with.

This failure inevitably opened the door to the post-Keynesian monetarist thesis. This essentially held that, so far from monetary policy being ineffective in suppressing the cycle, it was the ill-judged active use of monetary policy that largely caused the cycle. All governments needed to do was to maintain a consistent, steady, non-inflationary growth of the money supply—easier said than done—and the cycle would cease to be a problem.

There are insights in both these approaches; but at the end of the day both of them, I believe, have done more harm than good—and indeed continue to do.

Keynes's emphasis on mood swings from excessive optimism to unwarranted pessimism I find wholly convincing. One channel through which this can affect the economy, which has been important in a number of countries—including the United Kingdom—in recent years, is the credit cycle. The UK economy may be particularly prone to a pronounced credit cycle, as a result of our unusual pattern of housing tenure, with very little private rented accommodation and thus disproportionate emphasis on credit-financed homeownership; and the cycle was certainly further amplified in the 1980s by the once-for-all effects of financial deregulation.

But the essential phenomenon is a general one, by no means confined to this country. To put it at its simplest, when people are feeling confident they are likely to increase their borrowings and spend more than they earn. But sooner or later, they will inevitably reach a point at which they feel (or their bank manager points out to them) that their indebtedness has gone as far as—if not further than—is prudent, and they will rein back. If this ebb and flow is an individual phenomenon, then nothing follows from this; but as soon as it becomes a herd phenomenon, as it frequently does, then a cycle is born.

I find it wholly unconvincing to believe that the credit cycle (to take this one example: there are of course others) is caused simply by mistakes in monetary policy. Of course, such mistakes can exacerbate the cycle; but the cycle would be there without them. There is no way in which the monetary authorities can fine-tune bank lending, any more than they can fine-tune expectations. Friedman's famous observation that monetary policy works with long and variable lags is highly relevant in this context. Nor of course is there any way the authorities can predict the point at which the credit cycle is likely to turn of its own accord—although turn it inevitably will.

The harm that both these approaches to the business cycle do is twofold. First, the one thing they have in common is, I believe, profoundly mistaken. Both of them—and even more the two of them cumulatively—reinforce in the public mind what might be termed the myth of the straight line.

Keynesian economics has been popularly understood to say that macroeconomic stabilisation policy—in this case, fiscal policy—can prevent the discomforts of boom and recession, and ensure that the economy grows in a steady and sustainable straight line. So much so, in fact, that even fluctuations that last only a few months are seen as aberrations that call for explanation, rather than an inescapable feature of the real world. And monetarist economics too has been popularly understood to proclaim that it is within the power of the authorities—in this case, by avoiding monetary error—to ensure steady, sustainable, non-inflationary straight-line growth.

Surely by now we have enough experience in country after country throughout the world to know that this simply isn't true. For all practical purposes, the cycle is endemic. That is not to say that governments can or should do nothing at all about it. The maintenance of financial discipline at all times should not only keep inflation low—an important end in itself—but also make far less likely the emergence of an explosive boom. How financial discipline is best

maintained will vary from time to time and is in any case closer to an art than a science.

There is nothing intrinsically wrong with the Government's present practice of targeting inflation directly—*provided* it is not seen as any kind of auto-pilot. It is worth recalling that inflation as defined for these purposes remained within the authorities' current 1%–4% target range throughout the two years from March 1986 to March 1988—a time when, as we now know, the pressure of demand was growing considerably more strongly than was apparent at the time.

As for the risk of a slump, in the global economy of today stimulatory action is most unlikely to be warranted unless the threat itself is worldwide—that is, if global depression looms. In that case, worldwide—and preferably co-ordinated—monetary relaxation would be the right response. But that is not the case today, nor has it been at any time since the 1930s.

But what we are talking about here is the prevention of pathological extremes. What neither monetary nor fiscal policy can possibly do is abolish the cycle itself. Yet even now the UK authorities are promising just that: an end to the ups and downs of the past, and the nirvana of steady, sustainable, non-inflationary growth. (In parenthesis, it is worth adding that the claim is, in a sense, even bolder than that. For on the assumption that the economy is currently operating well below capacity—although no one knows how much below—it ought to grow for a time at a higher, unsustainable rate, to come closer to capacity, before slowing down to its long-term sustainable rate. The notion that it is within the authorities' power to deliver this, without any alarums and excursions on the way, is mind-boggling.)

But does it matter if people imagine—against all the evidence, not only in this country but abroad—that we are in a new era, in which the business cycle is a thing of the past? I believe it does. What Martin Taylor, the Chief Executive of Barclays Bank, recently referred to as the 'grotesque imprudence' of the banks during the late 1980s, was not only very damaging to the banks themselves. It also undoubtedly exacerbated the scale of the credit boom and thus of the subsequent recession. And it arose to a considerable extent because the banks, along with their customers, behaved as if the boom would go on for ever.

In other words, the ever-present awareness that we live, as we always have done, in a cyclical world could do more than anything else to prevent the excesses of optimism and pessimism that play such a large part in the cycle, and in so doing reduce the severity of the cycle itself.

I mentioned at the start the tax increases due to come into force in a couple of weeks' time, amounting to some $1\frac{1}{2}$% of GDP. For the sake of completeness, let me say that I would be astonished if they were to bring the recovery to a halt. In 1981, my predecessor as Chancellor, Geoffrey Howe, imposed rather larger tax increases, at the very trough of the recession, completely out of the blue. Yet despite the considerable shock, the economy never looked back. This time, the extra taxation has been well advertised in advance, and comes when the economy is already two years into the upswing from the trough of the recession. And contrary to popular mythology, the recession of the early 1990s has proved, however unpleasant, considerably less severe than the recession of the early 1980s.

There are, of course, other reasons for not expecting the tax increases to kill the recovery, among them the fact that $1\frac{1}{2}$% of GDP is equivalent to little more than the average change in the personal saving ratio in any year. All in all, in the cyclical world in which we live, the sheer momentum of the cycle, the natural rhythm of the economy, should never be underestimated.

I also mentioned earlier on that I believed that the obsessive focus of the economic debate on the short-term vagaries of the business cycle was damaging in two ways. The first of these ways is that, by not accepting these vagaries—and indeed the cycle itself—as inescapable features of the real world, and by expecting governments to ensure that economic life moves in a straight line, the cycle is actually likely to be more severe than would otherwise be the case. But the second aspect of the damage is more fundamental. Excessive concentration on the cycle—where the ability of government to improve economic performance is far less than is generally recognised—can all too easily be at the expense of focusing the attention of government on far more important matters, where their power for good or ill is in the long run considerably greater.

To identify what ought to be the primary concern of those responsible for the conduct of economic policy, and indeed the main focus of the wider economic debate more generally, we can do worse than remind ourselves of the full title of Adam Smith's magnum opus, *An Inquiry into the Nature and Causes of the Wealth of Nations*. For the difference in prosperity between those countries which have conducted their affairs reasonably successfully and those which have not is indeed striking. Yet for most of my lifetime—until very recently—there has been a curious reluctance to seek to understand this, as Adam Smith sought, in economic policy terms. For some, it has been seen as a matter of the exploiters and the exploited. For others, as an unalterable historical accident. For yet others, as an essentially cultural mystery. And for many, it has been seen as all of these.

This was never a convincing approach. It was never a convincing explanation, for example, of why those Latin American countries whose prosperity was on a par with that of the nations of Western Europe a century ago are so much worse off than us today. But it is two relatively recent events that have made that approach manifestly untenable.

One of these is the explosive growth and amazing economic success of a number of countries in East Asia. Here is a part of the world with a culture, history and civilisation wholly

different from ours. Yet like the western world, and unlike other developing countries, the high-performing Asian economies—to adopt the term used in the recent World Bank study, *The East Asian Miracle*—decided to embrace the market economy. Of course, the market economy cannot exist within a vacuum. So far from being the jungle it is sometimes characterised, it can flourish only in the right institutional context—above all, within the framework of the rule of law.

The World Bank study's conclusions about the reasons for these countries' outstanding success are worth spelling out—even though there is nothing in them that would have surprised Adam Smith. They can be summed up in the following five points:

- what are described as 'market-friendly' policies, including allowing the price mechanism to reflect economic scarcities, low protection, and flexible labour and capital markets;
- the maintenance of low inflation through monetary and fiscal discipline, involving positive real interest rates and firm control of public spending, leading to low budget deficits and in some cases budget surpluses;
- the encouragement of savings—largely as a result of the policies already enumerated;
- a high-grade bureaucracy, largely insulated from political interference; and
- heavy emphasis on universal education, notably at the primary stage.

Those were the conclusions reached by the World Bank's Research Report, published last year, on what they described as the East Asian economic miracle. Whether the World Bank's actions in the developing world are always entirely consistent with this analysis is less clear. But it is an analysis that is clearly echoed by the experience of Sir William Ryrie, who headed the International Finance Corporation for nine years, until his retirement at the end of last year, and who, in an impressive survey of the development scene delivered at Chatham House a few months ago, summed up in these terms:

> "What I am convinced of is that the market economy offers a prospect of strong growth and rising living standards to countries which have made only slow progress for several decades. I conclude that *the development task now consists chiefly of helping these countries to make a market economy work successfully.*"

The East Asian economic miracle is one of the two defining economic events of recent years, to which I referred a short time ago. The other is, of course, the collapse of Communism in the former Soviet bloc, largely as a result of economic failure on a scale that few had thought possible. Here is a part of our own continent, a part of the same culture as ours, with a high level of basic education and indeed a history of economic development—before the war, well within my own lifetime, the prosperity of Czechoslovakia was on a par with that of Switzerland. Yet the decision of its former leaders to abjure the market economy, including the institutions required to underpin it, condemned its people to a degree of relative pauperisation unique in the economic history of the world. The conclusion is inescapable, as the post-Communist leaders of those countries are for the most part well aware. They know that the overriding need is to create and develop a functioning market economy.

But, it may be objected, what has all this got to do with us? As a mature, developed economy with a fully-fledged market system, surely we have already done all that is necessary on that front; and policy-makers in the United Kingdom, as in the rest of the developed world, are quite right to devote their energies to seeking to eliminate the economic cycle? I have already indicated, in the early part of this talk, some of the reasons why I believe this to be profoundly mistaken. But there are other reasons too.

In the first place, such an attitude is dangerously complacent. Despite its success—and despite the worldwide consensus in its favour that has now, for the first time since the war, at last emerged—the market economy is always under threat of erosion by the lobbying of special interest groups, by the impatience of public opinion, and by the politicians' itch to meddle. If the condition of liberty is eternal vigilance, that is particularly true in the economic dimension.

But even if vigilance can prevent backsliding, are we really so sure that there is no scope for further progress? Are we really so confident that all the barriers to competition that should be removed have been removed? That privatisation has reached its practical limit? That our labour market is as flexible as it could be? That the tax system is as non-distorting as it should be? (There is certainly a risk of regression here.) Are we really so sure that public spending is under adequate control, looking at the medium and long term as well as the short term? That our institutional arrangements are incapable of improvement? That there are no unnecessary bureaucratic barriers to new-business formation and its financing?

The reforms which the Thatcher government put in place during the 1980s—and to which some of us devoted so much effort—were a substantial achievement. But it clearly would be quite extraordinarily complacent to believe that there is nothing further to do on these fronts. And if there is, then here is an important structural and supply-side agenda to which economic policy-makers should be directing their attention.

But there is another reason too why the developed world, including not least the United Kingdom, would be making a grave mistake in pandering to the seemingly ineradicable popular fixation with the short-term vagaries of the business cycle. Not so long ago, it was fashionable to worry that the nations of the world were irrevocably divided between the haves and the have-nots—with the gulf between them likely to grow ever wider. Today, the focus of concern has changed, as the most successful of the have-nots are dramatically closing the gap and fears are voiced that, without some form of protection, unskilled jobs in the developed world will be lost or unskilled wages unacceptably depressed by the low-wage competition from the more dynamic emerging economies.

And this fear comes at a time when, as the recent Detroit jobs summit demonstrated, there is already concern that technological development within the West itself is having precisely that effect.

The structural unemployment or wage problem is one to which policy-makers are clearly right to be turning their attention—and it is certainly far too complex for me to attempt to do justice to it at this late stage this evening. Suffice it to say that the United States has shown how new jobs can indeed be created in what remains the most technologically advanced economy in the world; that a high standard of basic education has never been more important (and far more fundamental, incidentally, than training—for it is the *capacity* to be trained and retrained that needs to be enhanced if the supply of labour is to upgrade itself to meet the new pattern of demand); and that, meanwhile, the tax and other burdens on employing unskilled labour should wherever possible be lightened—as indeed I lightened them on the National Insurance front during my time as Chancellor.

But the point I wish to make in this context tonight is that protection cannot and must not be part of the package. It is inevitable—and right—that different countries will feel they can afford different levels of social provision and environmental protection, depending on the stage of prosperity they have reached. But these differences can form no part of any justification for protection, any more than differences in national wage levels, which have always existed, have been accepted as a justification for protection.

Competition between firms in different countries is as beneficial to economic growth as competition between firms within a single country. Measures designed to hold back the development of the emerging countries are not only morally wrong and often politically dangerous: their economic effect can only be to hold back the growth of world prosperity to the detriment ultimately of the peoples of the developed world itself. Indeed, it is this common interest in global prosperity that is the foundation stone of international economic co-operation.

This, then, is the international agenda to which economic policy-makers need to address themselves—not as some optional extra, but as a major preoccupation.

Let me sum up my theme this evening in the following terms. Experience shows that the conduct of economic policy can have a profound effect, for good or ill, on the long-term prosperity of a nation and its people. Moreover, although the task is never easy, we also know from experience throughout the world—perhaps more clearly than at any time in the past—what the secret of success is.

By contrast, experience—not merely in this country but throughout the developed world—demonstrates clearly that we cannot eradicate the business cycle, the alternation of boom and recession, and indeed the short-term fluctuations in the rate of inflation that tend to be associated with it.

Yet paradoxically, despite these two well-established facts, the focus of economic debate in this country—and I suspect in most other developed countries—is almost exclusively on the short-term vagaries of the business cycle about which policy-makers can in reality do very little, rather than on the conditions for improved performance over the longer term about which, both nationally and internationally, much can be done.

There are, I suspect, three principal reasons for this extraordinarily perverse paradox. The first—and I list them in no particular order of importance—is the unfortunate legacy of Keynesianism. Keynes himself, writing in the mid-1930s, was of course concerned less with the avoidance of cycles than with the avoidance of slumps, which he mistakenly believed to be almost the natural condition of free economies. Hence, for example, his statement in the *General Theory* that:

> "The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom."

But it is not hard to see how, when Keynesianism came to be put into practice in conditions far removed from those of slump and the 1930s, it readily degenerated into a dangerously inflationary obsession with the cycle as such. And even if we have through bitter experience succeeded in inoculating ourselves against the inflationary aspects of Keynesianism, the short-term preoccupation with the cycle is as great as it has ever been.

The second reason for the paradox may be the passionate desire of the economics profession to believe that everything that matters can be reduced to mathematical equations and numbers. Since this cannot be done with any remote degree of plausibility for the Nature and Causes of the Wealth of Nations, Adam Smith's subject-matter must clearly be far

less important than the dissection of the business cycle, which so readily lends itself to mathematical and numerical analysis. Although a one-time mathematician myself, I am irresistibly reminded of one of Aldous Huxley's short stories, *Eupompus gave Splendour to Art by Numbers*. Eupompus in the story was a fashionable Alexandrian portrait-painter, who suddenly became obsessed with numbers. To quote Huxley:

> "Number seemed to him the sole reality, the only thing about which the mind of man could be certain. To count was the one thing worth doing, because it was the one thing you could be sure of doing right. Thus art, that it may have any value at all, must ally itself with reality—must, that is, possess a numerical foundation."

Eupompus thereupon founded a school of numerical painters, known as the Philarithmics—until one day, in a fit of madness, he killed a number of his followers and then himself. Huxley's narrator suggests that it was, in fact, a fit of sanity. Eupompianism in economics may have much to answer for too.

The third reason for the paradox about which I have been speaking this evening is, of course, the short time-horizon of the financial markets, of the media and all too often of governments faced with the problem of re-election. For all these, the cycle is perhaps bound to loom large.

But whatever the reasons for the perverse focus on what economic policy-makers cannot achieve at the expense of what they can, does it matter? I believe it does. It matters in political terms that the public are systematically miseducated on a matter as important as this is. And it is clearly a debasement of democracy if governments are to be elected or ejected largely on the basis of the particular phase of the inescapable economic cycle at the time an election is held.

But it matters in economic terms too. I have little doubt that perpetuation of the notion that the cycle can be avoided—what I have described as the myth of the straight line—is in practice likely to lead the cycle to be more pronounced than it might otherwise have been. And even more important, obsession with the vagaries of the cycle can all too easily lead those responsible for the conduct of economic policy to devote far less attention than they should to those issues, both at the national and the international level, that really will affect the prosperity of the people over the longer term.

That is a luxury neither this country, nor the world as a whole, can readily afford.