



BANK OF ENGLAND

Speech

“Economists and the Real World”

Speech given by

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Good evening. It is a great pleasure to be here to commemorate the 100th birthday of the BSc (Econ) at LSE. Those of you who know a little bit about the history of the LSE might, with reason, be a little puzzled by this as the School was actually founded in 1895 with lectures commencing on the 10th October of that year. In keeping with the Fabian founders' objective of facilitating the improvement of the lot of the working man through education and the pursuit of knowledge, those lectures were scheduled for the evening rather than the day. Fees were set at £3 per year - in relation to earnings, that would be equivalent to around £1100 in today's money - a curiously familiar figure!

The answer to the puzzle is that though the School from the outset offered a variety of courses within an ambitious three-year programme of study, they led to no qualification and there were no examinations - the latter is a feature I am sure would be of great attraction to today's students! Instead the lectures and classes were intended to be useful to candidates preparing for public professional examinations offered by other bodies, such as the Civil Service, the Council of Legal Education, the Institute of Bankers and the Institute of Actuaries.

But this arrangement did not last long. An 1898 Act of Parliament saw the creation of a federal University of London. In order to give credibility to the activities of the School, Sidney Webb and the first Director, William Hewins, made it their aim to persuade the University to add a Faculty of Economics and Political Science and make the LSE a college of the new University. That was achieved in the spring of 1900, paving the way for the creation of the BSc (Econ) and DSc (Econ) degrees. These were the first university degrees in the country devoted purely to the social sciences. But the need to develop curricula and examination schemes for the new degrees meant that students were not admitted to read for the BSc (Econ) until the 1902-3 Session. So that is why today is the Centenary, rather than 1995-6.

To obtain a degree, that first intake of BSc (Econ) students were expected first to pass an Intermediate Examination – which later metamorphosed into Part I – comprising four subjects: Economics, including economic principles and economic history; British constitution; Mathematics or statistics; and Geography (economic and political, rather than natural). Subsequently they would do courses in Economics;

History; Public Administration and Finance; an Essay; and a number of papers specialising in one of: Analytical and descriptive economics; Economic history; Political thought; Public administration; Banking and currency; International trade; Transport; Insurance; Statistics and demography.

That is a surprisingly modern-sounding list, and one that is not a million miles away from the menu that confronts today's undergraduates - though the content has certainly moved on a little since! And while subjects such as Sociology, Psychology, and International Relations have been added, that general structure of a broad introductory year across a range of disciplines, followed by progressively greater specialisation in one or two particular fields has remained. And though the BSc (Econ) was replaced in 1992 by new BSc degrees in Economics, Economic History, and the like, much of the essence of the old BSc (Econ) still lives on in the structure of the present degree schemes.

Even at the outset, the BSc (Econ) was never just an economics degree - indeed economics was itself a broader, if less deep, discipline than today, embracing also politics and moral philosophy as indicated by its older name of Political Economy. And over time the BSc (Econ) embraced progressively more of the emerging fields of social science. But economics has always been very much at the centre of the degree, and it is on economics that I will focus in the remainder of this talk.

Economics and the real world

When Richard Jackman invited me to give this birthday address, he suggested that in addition to saying a few words about the history of the degree, I might also usefully reflect on the contribution of economics, and LSE economists, to the wider world - hardly the narrowest of remits! Now the subject matter of economics is probably of more immediate relevance to the man in the street than that of almost any other social science. Economists study which goods consumers choose to buy and how much labour they choose to supply. They study how much output businesses produce, by what means they produce it, and what price they charge for it. They study how those businesses interact in various market settings, and how they choose to organise themselves. They study how economies grow, what causes inflation and

unemployment, and why there are periodic fluctuations in economic activity. And increasingly economists are applying the basic insights of the theory of choice under scarcity to all sorts of problems that one might not think of as being the natural domain of economics, such as marriage and even drug addiction.

I believe economics offers deep insights into these questions and, moreover, that those insights can usefully inform the design of policy and so improve the lot of mankind. But it has to be said that many non-economists, including many politicians, take a somewhat jaundiced view of the potential contribution of economics. In part that is because the conclusions of economic reasoning often seem to offend common sense. And in part it reflects the supposed tendency of economists to disagree, neatly encapsulated in Winston Churchill's exasperated observation that "If you put two economists in a room, you will get two different opinions; unless one of them is Lord Keynes, in which case you would invariably get three quite different opinions".

But "common sense" is frequently a poor guide to the right answer in economics. While sometimes sufficient for assessing the immediate effect of some change in the economic environment, "common sense" is often not so helpful at tracing through all the consequential adjustments and interactions in a coherent fashion. As a consequence many "common sense" nostrums are often fallacious. Let me cite a few examples to illustrate the point.

Consider first the impact of more immigration. A common belief is that these additional workers will simply displace indigenous employees, raising unemployment. This may indeed be the short-run effect, though as often as not the migration will itself be a response to unfilled job vacancies. But in any case the reduction in labour market tightness will then tend to hold wages lower than they would otherwise have been. That in turn will boost the demand for labour and encourage extra investment. In the long run, output will be higher and, under constant returns to scale, by the same proportion as the increase in the labour force.

As a second, though related, example consider the case of some technological advance that allows a firm, or sector, to produce the same output with less labour. From Ned Ludd onwards, "common sense" has had it that such technological progress

destroys jobs. Now it may indeed lead to immediate job losses in the firm where the advance occurs. But then again it may not, as the lower cost of production also allows the firm to lower its prices and boost the demand for its product. Whether employment rises or falls will then depend on how much the demand for the product is affected by its price. And if overall employment does fall, then the processes described above in relation to immigration will kick in, ensuring that the extra labour is brought back into use.

These are both examples of the “lump of labour” fallacy – that there is only so much work to go round. Economic analysis is useful in exposing the forces that ensure this is not, in fact, the case. But they are theoretical arguments - do they hold up in reality? Chart 1 shows that the labour force has doubled since the middle of the nineteenth century, while productivity has risen seven-fold. But Chart 2 shows that these increases in the labour force and productivity have not been associated with any increase in the unemployment rate, which shows marked fluctuations and occasional step-changes in level, but no discernible trend to match the ongoing increase in the labour force and productivity.

As another example where “common sense” can mislead, take the issue of international trade, so much to the fore at present with the debate over globalisation. My colleagues on the MPC and I spend quite a bit of our time meeting with groups of local businessmen through the Bank’s network of regional Agents, finding out about life at the sharp end. A common - if slightly caricatured - view we often hear is that international trade is a zero-sum game and that Britain is losing out because of the shifting of production to China and other low-cost developing countries.

Now as with the earlier examples there is a germ of truth in the businessman’s conventional wisdom. At the level of the individual firm, trade *is* close to being a zero-sum game. If my foreign competitor wins the orders, then I certainly lose out. But what is true at the level of the individual firm is not true at the level of the economy as a whole. As a nation we gain by importing goods and services that are cheaper than we can make them at home, exporting in return goods and services that are cheaper for us to make. So both our trading partners and we benefit from the extra trading opportunities that international trade brings. At this point the non-economist

will often argue that surely we cannot produce anything tradeable more cheaply than the Chinese given their very low labour costs? But in that case all production of tradeable goods and services would move to China, precipitating counteracting movements in wages and prices both there and here. The great – and to a non-economist counter-intuitive – insight of trade theory is that it is comparative, not absolute, advantage that ends up governing the international pattern of production and that trade is generally beneficial to both parties.

Viewed from this perspective, the displacement of low cost production to China, Eastern Europe and other low cost producers, together with the associated decline in the share of manufacturing that is observed in all developed economies (see Chart 3), should be recognised as reflecting the working out of the principle of comparative advantage. Moreover, that is also part of the process whereby living standards in the developing countries rise - all the evidence suggests that international trade is good for growth in living standards, something that many of the critics of globalisation seem to be blithely unaware of.

To be sure, there are important distributional issues that are thrown up by these examples. If migration is concentrated amongst particular skill groups or if technical progress affects the demand for a particular type of labour, then the distribution of wages will be affected. And in the trade example the returns to those factors that are relatively scarce in a country will tend to fall in relative terms - at the current juncture that means the wages of the relatively unskilled in the United Kingdom. Indeed both skill-biased technical change and globalisation are possible explanations for the widening in the distribution of earnings in the United States and the United Kingdom over the last decade or so.

Exposing the fallacy, or at least incompleteness, in the “common sense” view of these problems does not involve any great technical firepower. Indeed I would expect anyone who had sat – and passed – a second-year Economic Principles course to be readily able to construct the arguments. And there are many other examples one could give where even quite basic economic analysis points to a different conclusion from that given by “common sense”. Mostly that is because “common sense” does not properly take account of the way economic agents adjust their behaviour and how that

leads to associated changes in prices and quantities through the market mechanism. It is tracing through these adjustments and seeing how the whole story plays out that economists tend to be better at. And it is because there can be legitimate differences of view about the quantitative importance of the different effects and channels that two economists who share the same analytical apparatus may nevertheless end up disagreeing about the final result. But overall I believe economists have far more in common than Winston Churchill's caricature suggests.

It is this ability to understand how agents might change their behaviour in response to an alteration in their environment, and how those changes feed through the economy that is most valuable when the economist becomes a policy adviser. The first inclination of many policy makers is often to attack the symptoms of a problem rather than its underlying causes. The response is frequently to impose controls through legislation, which as often as not may turn out to be counter-productive or else end up having unintended consequences. By asking what the underlying cause is, where the market failure is, and tracing through the full consequences of a policy intervention, economists can guide decision makers towards the implementation of policies that are both more effective at achieving their intended objective and in avoiding any associated unintended consequences.

LSE economists and the real world

The LSE has always set great store by the practical aspects of economics. The original 1895 prospectus stated that "the special aim of the School will be, from the first, the study and investigation of the concrete facts of industrial life and the actual working of economic and political relations as they exist or have existed, in the United Kingdom and in foreign countries". This emphasis on economics as a practical tool both to understand, and to improve, the world is exemplified by the many faculty members, not to mention alumni, who have played a role at some time in the formulation of public policy here or overseas.

For some it has been by moving out of academia into politics. William Hewins, the first Director and an economist with a bent towards history, became a Conservative MP engaging with the campaign for tariff reform. But perhaps the most notable

faculty member who moved into politics was Hugh Dalton. A member of staff for nearly twenty years, he went on to achieve high office as Chancellor of the Exchequer in the post-war Labour government. Some have managed to combine a role in politics with continued activity in academia through their elevation to the House of Lords, including two current members of the department.

But more frequently LSE economists have impacted on policy through their advice. Perhaps the most notable of all was Lionel Robbins. Also a former student, Robbins joined the staff in 1925, rising meteorically to a Chair four years later. As well as being a key influence in the development of economics at LSE during the 1930s, his influence and involvement outside was substantial. In 1930 he was appointed to a Committee of the Economic Advisory Council, chaired by Keynes, whose task was to identify the causes and remedies for the developing slump. Robbins and Keynes had very different views – Keynes was groping towards the ideas that would be elaborated at length six years later in the *General Theory*, while Robbins with his neo-Austrian approach was instinctively less interventionist. They disagreed in particular over the question of trade protection, leading Robbins to submit a minority Report creating a certain amount of ill feeling.

That disagreement with Keynes subsequently broadened out into a wider intellectual debate over the validity of the Keynesian vision and the relative merits of deflation and demand management in fighting recessions. While relations with Keynes were frosty during this period, they were later to work together in perfect harmony, first when Robbins joined the Economic Section of the War Cabinet and subsequently when he accompanied Keynes to the Bretton Woods conference that drew up the blueprint for the post-war international financial order. Finally, mention should be made of Robbins' later contribution to education policy in his role as chair of the Committee on Higher Education that paved the way for the great expansion of higher education that took place in the late sixties.

Robbins is not the only policy giant of the 30s and 40s. One must also mention William Beveridge, Director of the School from 1919-37, whose wartime report under the unprepossessing title *Social Insurance and Allied Services* recommended the establishment of a national health service, national insurance and assistance, family

allowances, and stressed the importance of full-employment in alleviating want. That report laid the foundations for the post-war welfare state.

As we move into the post-war period, so it has become more common for academic economists to cross the boundary into the provision of policy advice. In a short lecture I cannot hope to do justice to the many LSE faculty who have contributed to the formulation of economic policy in some way or other. But even in my time at the LSE I can think of members of the department who have been actively involved on such matters as: the design of the tax and social security system; efficiency of delivery in public spending; the organisation and finance of higher education; urban and transport policy; the implementation of competition policy; policies to fight unemployment; reform of the international financial architecture; development policy, often through the auspices of the World Bank; and post-communist economic reform. The list is virtually endless.

Furthermore the influence of LSE economists on public policy is by no means confined to those who have served as policy makers or advisers to policymakers. As Keynes once observed “practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist”. Those toiling away developing the theoretical and analytical foundations often have a major impact through the way they influence the thinking of other, perhaps more practically oriented, people. Nine economists connected with the department have been awarded the Nobel Prize, and their contributions have profoundly affected the way others approach problems.

Given the range of policy questions to which LSE economists have contributed, rather than try to cover everything I thought I would do better just to make a few brief remarks relating to some of the contributors in my own field of macroeconomics.

I have already mentioned the LSE v Cambridge debate about the validity of the Keynesian vision – an exchange in which it has to be said the LSE was on the losing side. In the years after the Second World War the key objective for macroeconomics was the refining of the Keynesian vision. Much of this was conducted in the framework of Hicks’s IS-LM apparatus, a distillation of the model of the *General*

Theory - Hicks had of course previously also been a member of the LSE staff. But the IS-LM model was incomplete, as it said nothing about the determination of prices. It was that hole that a member of the department, Bill Phillips, plugged with his discovery of an apparent inverse relationship between wage inflation and the level of unemployment (see Chart 4). Though Phillips was not himself engaged in active policy advice to any great extent, his empirical relationship represented a seminal contribution to the conduct of macroeconomic policy. It has also represented the key battleground for controversies over macroeconomic policy since and provides a convenient backdrop against which to describe some of the other LSE contributions in this field.

Phillips' contribution appeared to imply that there was a trade-off between the level of activity and inflation – though it should be said that Phillips' own interpretation was more subtle. Governments could have higher output and lower unemployment if they were prepared to accept higher inflation. To many macroeconomists the broad structure of the macroeconomy had now been settled and all that was left was to fill in the details. The decade following the publication in 1958 of Phillips's article marked the highpoint – some would say nadir – of the application of Keynesian fine-tuning to steer the economy.

But a fundamental challenge to this view was brewing, in the person of Milton Friedman. Friedman's 1968 exploration of the analytical foundations of the Phillips relationship cast doubt on the existence of such a long-run trade-off between activity and inflation and indicated that output could rise above its natural rate only for as long as inflation was higher than agents expected. Attempts to exploit the apparent short-run trade-off to raise output above its natural rate would in due course merely lead to that trade-off shifting upwards as expectations adjusted. Moreover, the impact of macroeconomic policy on demand was uncertain in both magnitude and timing, making any attempt to eliminate fluctuations around the natural rate potentially counterproductive. According to his view of the world, the best policymakers could do was to eschew the fine-tuning of activity and simply keep the money supply growing at a low and steady rate, thus guaranteeing low inflation over the medium term.

While the key players in this monetarist counter-revolution were based at Chicago, Harry Johnson and Alan Walters at LSE both played a significant role in espousing those ideas on this side of the Atlantic. The latter achieved a notable success by correctly predicting that the rapid monetary expansion of 1972-3 under the Barber boom would be associated with a subsequent acceleration in inflation rather than higher activity (see the blue segment in Chart 5). Increasingly politicians retreated from the Keynesian approach and recognised the importance of monetary control, the adoption of monetary targets by Denis Healey in 1977 being a pre-cursor to the wholesale embrace of monetarist thinking by the Thatcher government. Walters, of course, subsequently became Mrs Thatcher's personal economic guru, and in that role was highly influential, notably in arguing against sterling joining the European exchange rate mechanism.

The period thereafter was marked by continually rising unemployment in both the UK and many other European economies (the red segment in Chart 5). In part this was the result of the pursuit of counter-inflationary macroeconomic policies, but the persistence of high unemployment once inflation had stabilised was a puzzle that the monetarist model could not immediately explain. Not only did the short-run trade-off shift up and down as inflation expectations rose and fell, but it also appeared to shift in and out. Richard Layard, Steve Nickell and others at the LSE's Centre for Labour Economics were at the forefront of showing how this was related to the nature of labour market institutions and how temporary shocks could have persistent effects. That contribution has also proved influential in the debate over appropriate policies for the labour market and particularly in the design of Labour's New Deal.

My final episode in the life of the UK Phillips curve concerns the period since Britain's exit from the Exchange Rate Mechanism in 1992 and the subsequent adoption and of inflation targeting (the green segment in Chart 5). Recently arrived from LSE, Mervyn King, then the Bank of England's Chief Economist played a key role in persuading the Treasury of the virtues of an inflation target. And of course since the Bank was given operational responsibility for setting interest rates in 1997, LSE has been strongly represented on the Monetary Policy Committee: no less than six of the eighteen people who have sat on the Committee have been members of the department at some time or another.

It is often said that central bank independence is desirable because it takes the politics out of monetary policy. But an equally important feature of the present UK arrangement is, I believe, the extent to which it has also put economics right at the centre of monetary policy. The MPC is a committee composed of economists and economically literate technocrats - to a degree that is probably unique - and I believe that greatly facilitates our deliberations.

When we meet each month to set the official interest rate we are confronted with masses of economic and survey data, often giving conflicting signals, not to mention a mass of qualitative information from the business contacts of our Agents. The Chartpack that we take into the Committee room contains more than a thousand individual data series and charts. Drawing together all this information so as to get a picture of where the economy is, let alone where it is headed is by no means a straightforward task. Quantitative economic models can help, but need to be accompanied by a lot of independent critical analysis and a good dose of judgement.

There is certainly no guarantee that a committee of economically literate individuals will always get the policy judgement right, but in my view they have a better chance than one composed of individuals with little or no facility in economic analysis. That is particularly so at times of turbulence and great uncertainty like the present, when there is a real premium in being able to separate the substance from the froth.

Has the MPC delivered what it is supposed to? As Chart 6 shows RPIX inflation has stayed quite close to, though mostly a little below, our mandated target of 2.5% in the period since independence. In the context of past UK inflation performance that is not at all bad, and moreover that has been associated with a growth performance that has for the most part been relatively good compared to the other G7 countries.

Now it would be unreasonable to expect inflation to be always exactly 2.5%, as there are bound to be unanticipated shocks that we will be unable to offset, or else may choose to accommodate in order to avoid undue volatility in output. But some observers have taken us to task for allowing inflation to persistently undershoot the target in the period since 1999. That undershoot - averaging around $\frac{1}{2}$ percentage

point - has certainly not been by design. Each quarter we publish conditional projections for inflation and growth, as a probability distribution or “fan chart”, in our *Inflation Report*. Our mean projection for inflation two years ahead has always been very close to 2.5%, so that our average two-year ahead forecast error has also been about ½ percentage point.

This small, though persistent, undershoot is less significant than it appears. Inflation is a persistent process - indeed quite close to being a random walk on quarterly data – and it can take a year and a half or so for most of the effect of a change in interest rates to feed through to inflation. The consequence is that even if our forecasts were optimal and the forecast errors for quarterly inflation random, the prediction errors for annual inflation two years ahead should be highly persistent, as would therefore also be true of the outturns of inflation compared to the target. A report on the Bank’s modelling and forecasting activities by Professor Adrian Pagan of the Australian National University that will be published tomorrow includes a simple statistical analysis of our past forecast errors. His analysis suggests about a one in five chance of observing a run of eight consecutive quarters with forecast errors of the same sign even with an optimal forecast. The analysis also implies that just a small bias of 0.02 percentage points in our projection of the quarterly inflation rate would be enough to generate an average undershoot of the magnitude observed.

Of course, that is not to say that we should not try to learn from even relatively small errors. The forecasting error can be traced to the unexpected strength of sterling in the first part of the period and a better-than-expected supply performance thereafter, and the Committee has over time absorbed this into its analysis.

But a more interesting feature, in my view, than the undershoot is the overall stability of inflation over this period, reflected in the apparently very flat Phillips curve over the last decade, and the fact that since independence the Governor has not had to write an Open Letter to the Chancellor as would have been the case had inflation strayed more than one percentage point from target. An unresolved question is whether this stability, which has coincided with remarkably stable growth, is mainly down to: the change in monetary regime and the associated anchoring of inflationary expectations; the result of structural changes to the economy, including a better functioning labour

market, the effects of ICT and enhanced international competition; or just down to a fortuitous sequence of shocks. That bears on the question of whether we can expect such relative stability to continue in the future or not.

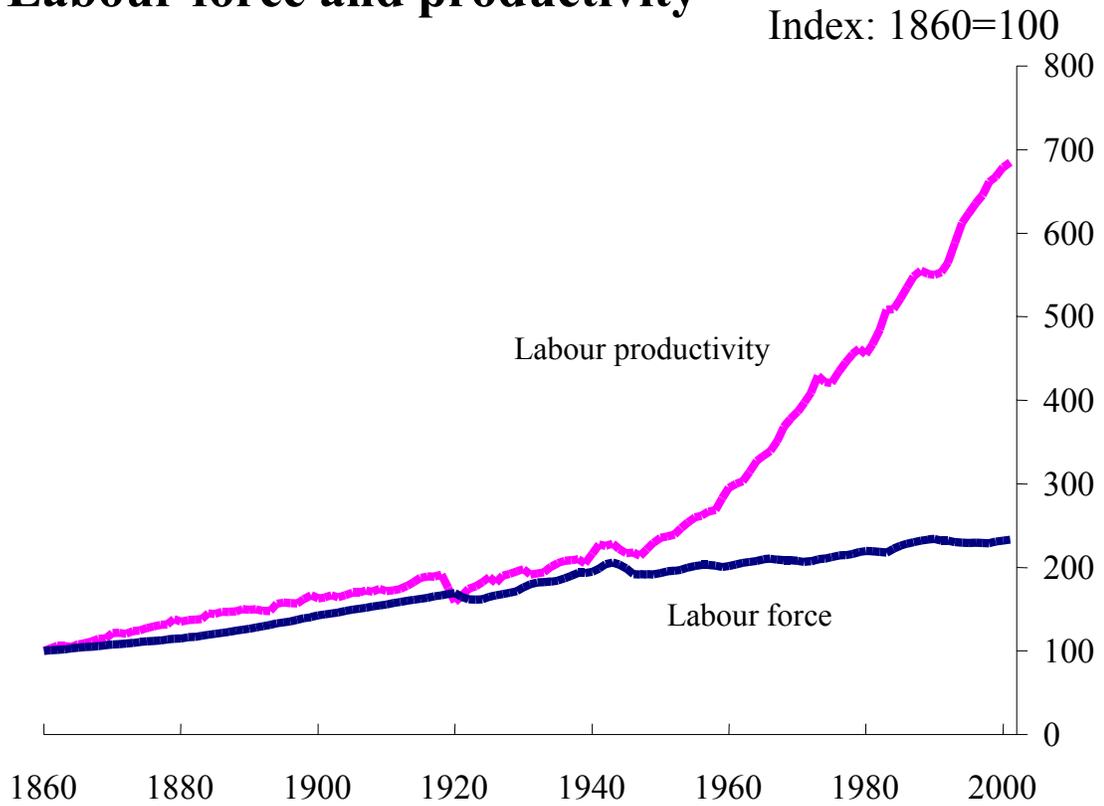
The present environment is a challenging one for the MPC. Against the background of a sharp global downturn, the UK economy has managed to keep growing at only a little below its trend rate. But that has been achieved only through boosting domestic demand – and especially consumer spending – to offset the external weakness. Consequently beneath the surface there have been significant and growing divergences between the performance of the tradeable and non-tradeable sectors of the economy. So long as the global recovery remains patchy it is important that domestic spending remains strong, but eventually spending will need to slow and the associated imbalances unwind. Achieving such a rebalancing smoothly would be quite an achievement, especially against the particular uncertainties posed by the current threat of war in Iraq and the fragility in financial markets.

Beyond these immediate concerns, we and other central banks are grappling with a range of issues concerning the appropriate conduct of monetary policy in a world of low inflation such as: What role should asset prices and financial imbalances play in the conduct of monetary policy? Is deflation a potential problem and what can policy do about it? And how will the return to a low inflation environment affect the behaviour of economic agents?

Mervyn King, now the Bank's Governor-designate, once said in a speech from this very spot that his objective was to make monetary policy boring. I do not know whether we have succeeded in that yet, but one thing I can assure you of is that the *making* of monetary policy is certainly not boring. If there is one thing I am sure about, it is that LSE economists will continue to contribute to the making of better monetary policies as much in the next century as it has in the last one. And I am sure that will be equally true of the many other areas of policy making where economics has so much to offer.

Chart 1

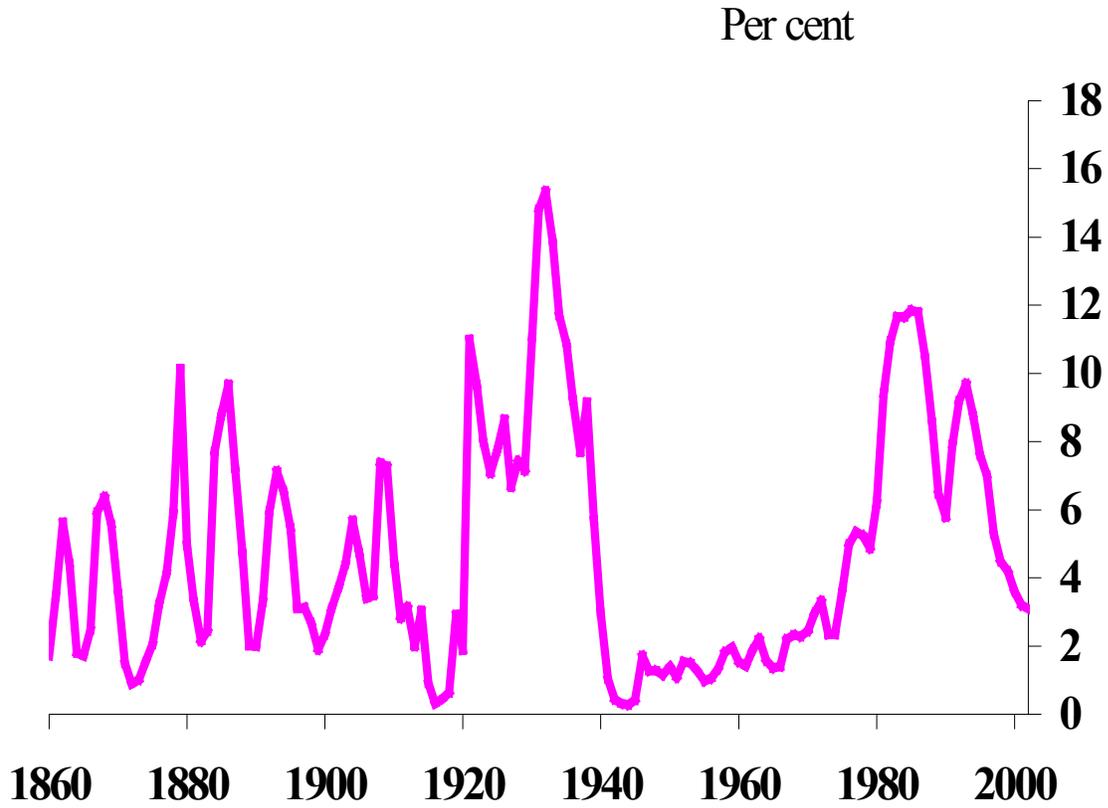
Labour force and productivity



Sources: Mitchell, "British Historical Statistics", Economic Trends Annual Supplement, ONS.

Chart 2

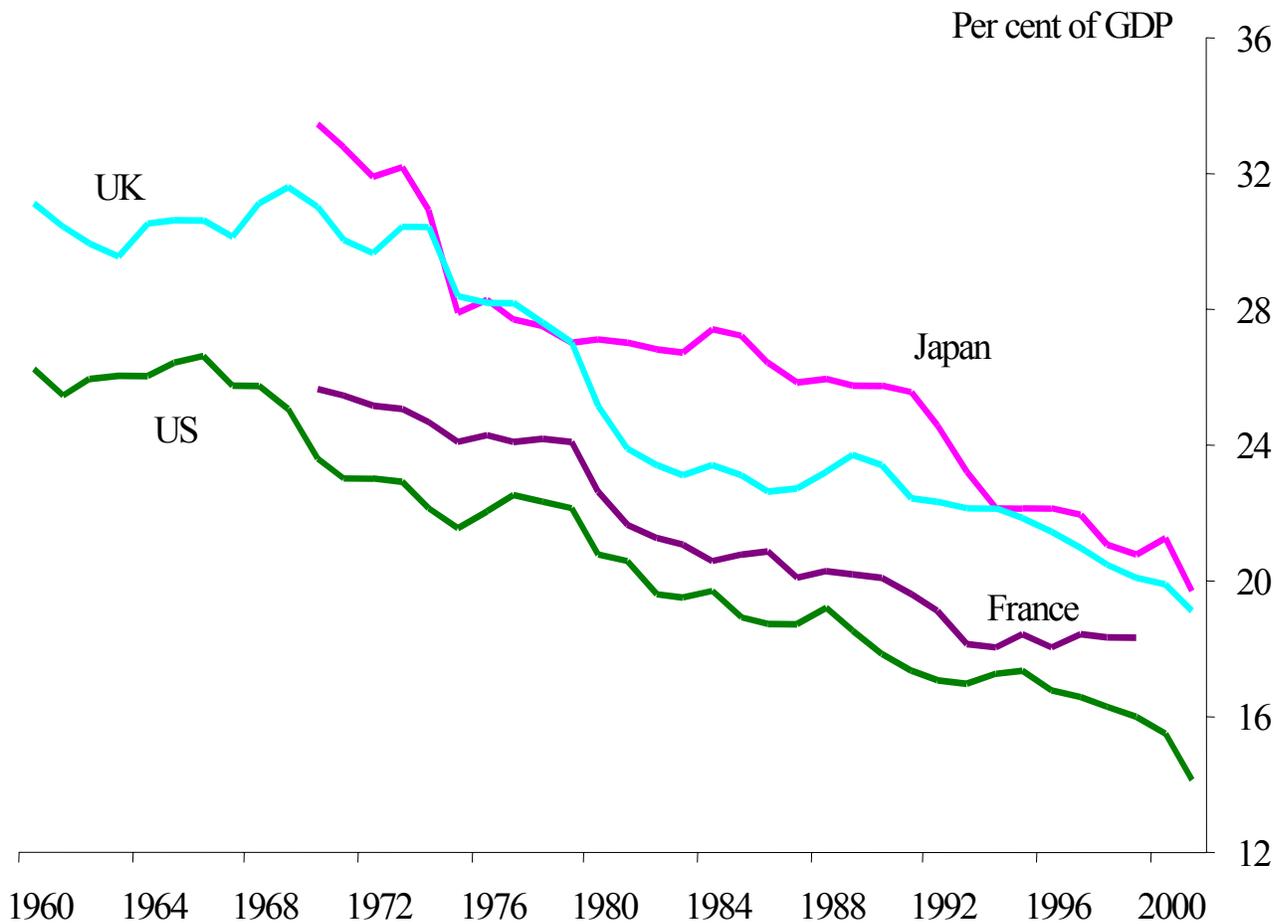
Unemployment rate



Sources: The Economist, ONS.

Chart 3

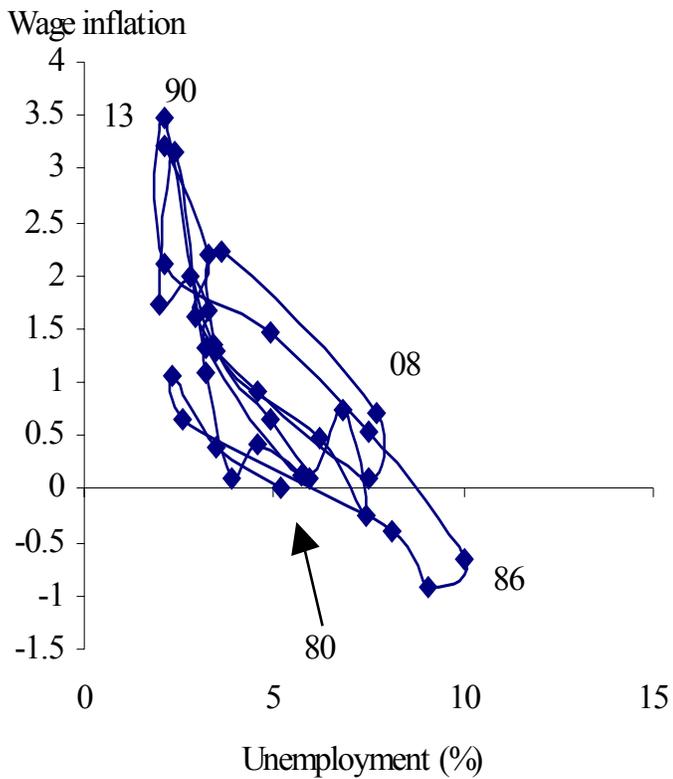
Manufacturing output share of GDP



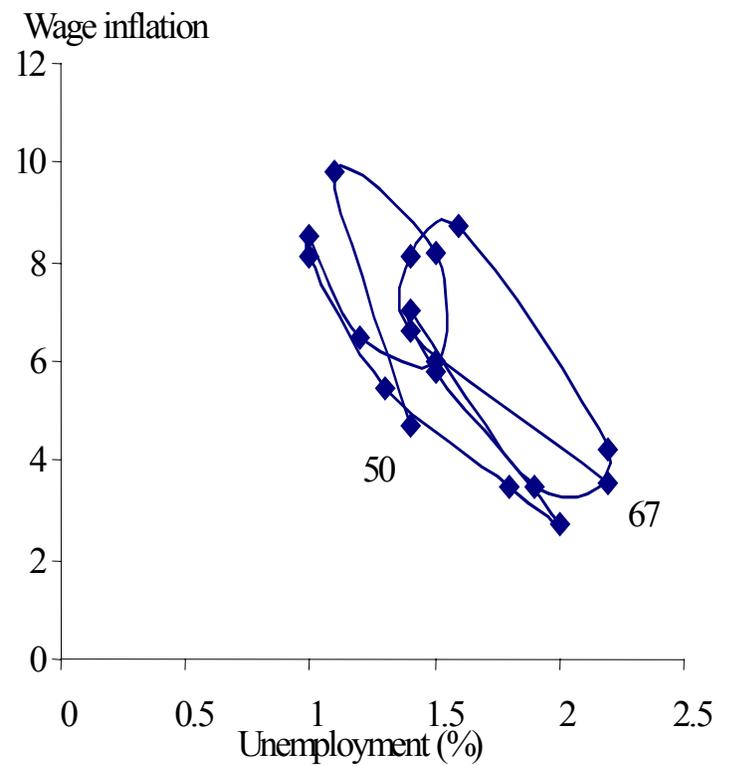
Sources: ONS, OECD, US Bureau of Economic Analysis, Cabinet Office of Japan and Bank of England.

Chart 4

Phillips Curve, 1880-1913



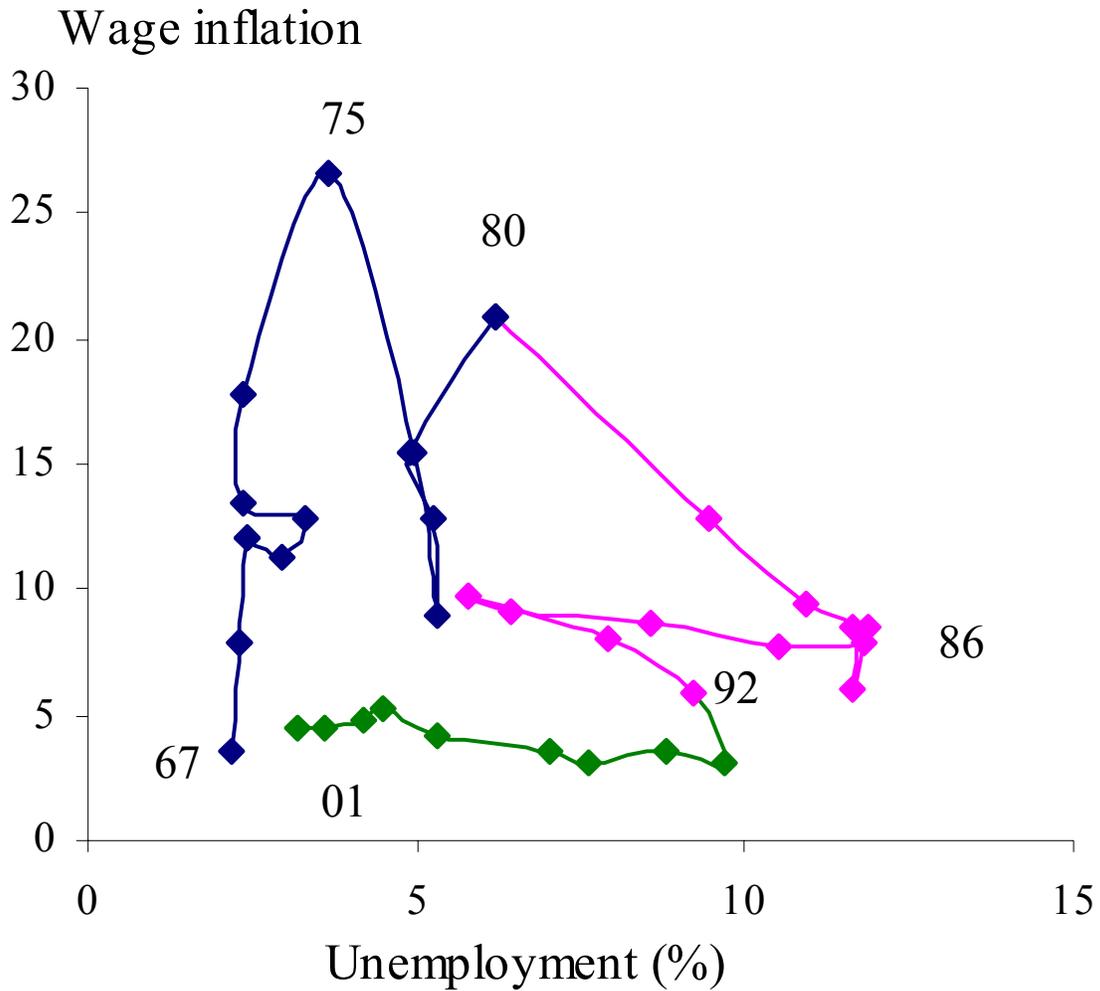
Phillips Curve, 1950-1967



Sources: Crafts-Mills, *Exp. Economic History*, 1993; Feinstein, "Nat. Income, Expenditure and Output, 1855-1965"; Economic Trends Annual Supplement.

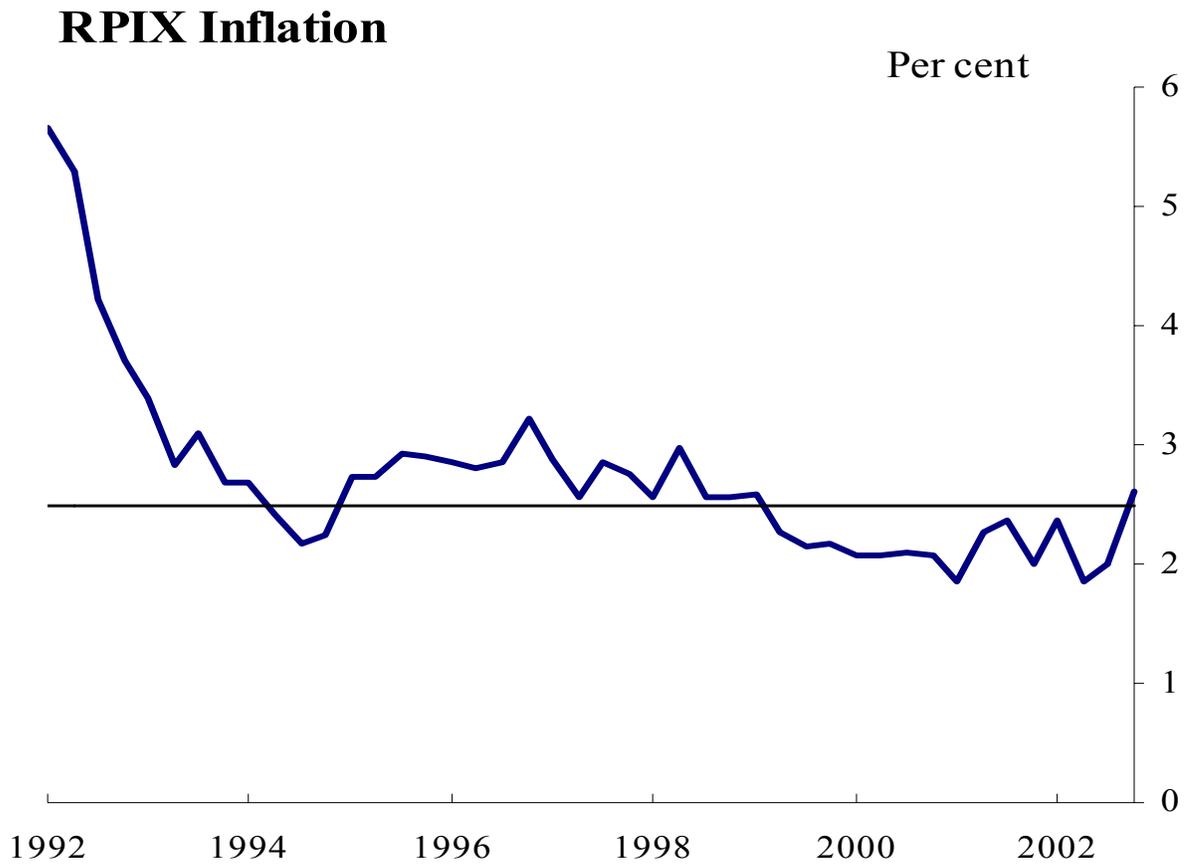
Chart 5

Phillips Curve, 1967-2001



Sources: Crafts-Mills, Exp. Economic History, 1993; Feinstein, "Nat. Income, Expenditure and Output, 1855-1965" Economic Trends Annual Supplement, ONS.

Chart 6



Source: ONS.