# Banking on Stability:
## A framework for economic success

Edward George

POLITEIA

2008

First published in 2008
by
Politeia

22 Charing Cross Road
London WC2H 0QP
Tel: 020 7240 5070 Fax: 020 7240 5095
E-mail: info@politeia.co.uk
Website: www.politeia.co.uk



Policy Series No. 60

ISBN 978-1-900525-93-0

Cover design by John Marenbon

**Politeia gratefully acknowledges support for this publication from**
The Foundation for Social and Economic Thinking

Printed in Great Britain by:
Hobbs the Printers Ltd
Brunel Road
Totton
Hampshire
SO40 3WX

THE AUTHOR

Lord George was Governor of the Bank of England from 1993 to 2003. He joined the Bank after graduating from Cambridge in the early 1960s and remained there apart from secondments to Moscow State University, the Bank for International Settlements and the International Monetary Fund. He was appointed Governor in 1993, and retired on the completion of his second five-year term of office at the end of June 2003. In 2004 he became a life peer.

## Introduction

Over the course of my career at the Bank of England, spanning forty years or so, a number of fundamental changes to our whole approach to macro-economic management occurred in this country, and from different starting points and in varying degrees around much of the rest of the world. Against such a background, this address will discuss the recent turbulence in global financial markets and will consider some of the implications for financial regulation in the future.

Beginning with the change in approach to macro-economic management, it will consider first the change in approach to the supply side of the economy. This is particularly important, because our supply side capacity essentially determines the rate of growth that we can hope to sustain over time of output, of employment and of incomes.

## A Changing Approach to Economic Management

I joined the Bank of England straight from university in the early 1960s. Shortly afterwards, in 1964, I was sent to Moscow for the best part of a year to study the Soviet economic and financial system. It proved to be a seminal experience. It very quickly became apparent that the centrally planned and controlled Soviet system was not working well. There was a disjunction between what the central planners decided should be produced and what consumers wanted to buy.

There was a story doing the rounds in Moscow then, about a nail-producing factory. As the year-end approached the factory was behind its production target. So, in order to catch up it produced a single, massive and totally useless 10-ton nail. And they were even paid for producing the nail by Gosbank, the Soviet Central Bank, which at that time was more of an accounting organisation than a financial institution. The story was probably apocryphal. But a visit to GUM, the retail store alongside Red Square, showed that things were not working well: row upon row of empty shelves alongside row upon row of shelves packed with goods overflowing into the aisles that no one wanted to buy. Though Nikita Khrushchev, who was then in power, sought to introduce a form of the profit motive to improve things, he was removed from office in October 1964.

On returning to the UK, my Soviet experience made its full impact upon me. For the first time, I realised just how centrally managed and controlled we too were in this country. Having grown up in that environment, I had, until then, taken it for granted.

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

But it didn't stop at the financial system. In the wider economy there were prices and incomes policies. There was also state ownership of vast swathes of industry, with very powerful trade unions secure in the knowledge that their employers could not go bust. And there were marginal rates of income tax which at one point reached an unbelievable 98 per cent on investment income.

Virtually all of this has now, happily, gone. Over the next 30-odd years we moved, very gradually – at times imperceptibly – to a much more market-based system. Yes, of course, there are still rules and regulations, as there must be in some degree for economic reasons. Markets must be reasonably fair as well as free if they are to perform their function effectively. But rules and regulations are needed also for social reasons. Regulation can, and no doubt does in some respects, go over the top: it is often not obvious, as a matter of degree, where the balance can be most effectively struck. But the difference is that for the most part, the rules and regulations of today, at least in relation to the economic and financial system, do not dictate what can and cannot be done. Rather they tell us what criteria must be met, and what standards must be observed, in pursuing whatever course is chosen. That leaves much more room for competition between producers nationally and to a considerable extent globally, and allows far greater freedom of choice on the part of consumers. And that in turn engages the ideas and imagination, the energies and enthusiasms, of people at large within our society, rather than leaving everything to be determined at the centre.

All of that has had a positive effect on the supply side of our economy which is fundamentally important in terms of our productive potential. But there have been equally fundamental changes, gradually over time, in our approach to management of the demand side of the economy.

For years, fiscal and monetary policies were operated largely in tandem, often together with direct controls. The broad objective was to manage what was seen to be a trade-off between growth and employment on the one hand, and inflation and the balance of payments on the other. If growth slowed and unemployment started to rise, both the fiscal and monetary policy levers were pushed forward to 'go', together, until inflation and the balance of payments threatened to get out of hand. At that point the levers were brought back to 'stop'. This go-stop approach to demand management tended to aggravate the boom-bust economic cycle. And worse still things threatened to become explosive, with inflation progressively higher from peak to peak and unemployment higher from trough to trough.

We gradually learned from that experience that there really is no trade-off between growth and inflation, except possibly in the short term, but not necessarily even then, given the short termism in economic decision-making that it engendered in the population at large. We learned, too, that fiscal policy is in fact a cumbersome instrument for demand management, given the time it takes to put it into effect; and we began to focus increasingly on the ratio of government debt to GDP over the medium-to-longer term as a fiscal policy constraint.

This was to leave a more specific role for monetary policy – essentially, by now, the management of short-term interest rates, in the approach to overall demand management. The objective was not that of managing the earlier, perceived short-run trade-off between growth and inflation. Rather it was to keep overall, aggregate demand growing consistently over time broadly in line with the underlying supply-side capacity to meet that demand. We came to terms in fact with the near-universal central bankers' mantra that 'stability is a necessary condition for sustainable growth'.

That objective was eventually reflected in a low and stable, symmetrical inflation target, not simply as an end in itself but as a measure or barometer of stability in the wider sense of the balance between aggregate demand and the underlying supply-side capacity of the economy to meet that demand. That eventually led to operational independence for the Bank of England in the field of monetary policy — and the creation of the Monetary Policy Committee over a decade ago.

### 2007 – An Economic and Financial Turning-Point?

The important point is that all of these fundamental changes in approach on both the supply and demand side of the economy, came about as a result of an emerging consensus across a broad part of the political spectrum. It was like a complicated jigsaw puzzle gradually coming together. It has worked well for us in the UK over the past 10 – 15 years, with consistent quarter by quarter growth at an average annual rate of around 2 ¾ per cent; a consistent rise in employment to an all-time high and a fall in unemployment to a 30-year low; and with inflation consistently low and relatively stable. That has happened despite the Asia crisis in the nineties and the mild recession in most other industrial countries following the dot.com bubble in the early 'noughties'.

Only a year or so ago, the global economy as a whole was looking in pretty good shape. GDP growth led by the US and also by emerging markets, notably China and India, had recovered to around 5 per cent a year, the highest for three decades. Inflation was still reasonably low though it had begun to pick up on the back of rising energy, commodity and food prices. Although there were some dark clouds on the horizon, notably global and domestic imbalances, they did not seem to be immediately threatening. But then the sudden storm hit global financial markets last summer, a stark reminder that economic and financial stability go hand in hand. There cannot be one without the other.

With the benefit of hindsight we all should have seen the storm coming. In the face of the economic slowdown in the industrial world in the early years of the decade, when inflation was generally under control, official interest rates generally were reduced to abnormally low levels. Nominal rates were around zero for much of the time in Japan; and they troughed at 1 per cent in the US, 2 per cent in the Eurozone, and 3 ½ per cent in the UK. That had already given rise to potential social, as well as economic, concerns relating in particular to a rapid rise in household debt and rapidly escalating house prices in many countries. We were very conscious of this internal imbalance in the UK and tried hard not to do more than had to be done to keep the economy moving forward even though inflation was somewhat below our symmetrical inflation target for some of the time. But what, perhaps, was not anticipated were the wider financial market consequences of what came to be called the 'search for yield'.

There were two sides to this equation. Those with money to invest – insurance companies, pension funds, hedge funds, sovereign wealth funds and so on – showed an increasing appetite for marketable debt assets yielding higher returns. That provided an incentive for other financial intermediaries, notably banks, to increase their earnings through fees on the origination of loans which might initially be held on their balance sheets funded by borrowing in the wholesale money markets, but which could then be sold down into the market-place. And the banks were not at all slow to respond to that incentive.

Over the past five years, the intense competition and technical innovation in loan origination and distribution, through marketable debt instruments, has resulted in an entirely new and predominantly acronymic language. I was aware of 'sub-prime' lending (though not the potential scale of it) before I left the Bank and familiar with expressions like 'cov-lite'. I understood the principle of 'securitisation', but CDOs, CLOs, ABSs and ABCPs not to mention CDSs and monoline insurance were all pretty much still in their infancy. Nor do I really understand the highly sophisticated slicing of debt into different tranches of risk or how they are related, particularly when they include market trigger points in addition to the default risk on the underlying asset. I don't understand how they are related or even rated.

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

That is not to suggest that the financial world went completely mad. The new instruments and techniques will no doubt have contributed to economic activity, at least in the short term. And in principle the spreading of risk across the financial system, nationally and internationally, ought to mean that while individual financial institutions can still fail, and that is inherent in a market-based system, there is actually less risk of a systemic crises than before. But that is not what has been seen since last summer.

An important part of the explanation is that, as things have turned out, the scale of debt origination and of selling the debt down across the global financial services industry has reduced the transparency of the overall extent of debt within the system as a whole. It has also obscured awareness of where the risk has ended up.

Many markets commentators, regulators and central banks, including the FSA and the Bank of England in this country, had expressed unease about the 'search for yield' for some considerable time before last summer. But no one, anywhere, to my knowledge, ever anticipated the dramatic events that we saw last summer.

As it was, the surprising revelation of substantial US sub-prime losses in two relatively small German banks prompted a frantic re-examination across the financial system everywhere of the possible scale of outstanding debt and where it might be located. The almost instant reaction was a wholly unprecedented freezing up of the markets in securitised debt instruments and in the wholesale money markets. Banks that in fact had adequate liquidity were reluctant to lend, certainly for more than a few days, because they did not know the extent of the exposures of borrowers in the money markets, or how much of the debt (that they themselves had originated very often) they would have to retain or take back on to their books. Many faced massive write-downs as the price of their holdings fell. Not only did this affect US sub-prime debt; but marketable debt instruments more generally declined, if indeed a market price could be identified.

Happily the major central banks have succeeded in calming things down in the wholesale money markets. They have made very large amounts of liquidity available, for longer periods, against a wider range of collateral, and at less penal rates of interest. It's too soon to say that the systemic liquidity crisis is over. There will no doubt be further alarums and excursions through the year. But, as I see it, the central banks are very much on the job and have things under reasonable control.

Many banks and other institutions have had to make massive provisions reflected in their share price, and raised large amounts of additional equity. Some senior executives have lost their jobs. It's been a very tough time. But the only real catastrophe here in the UK has been the sad case of Northern Rock, which was an extreme case of reliance for liquidity on the wholesale debt and money markets.

The debate about Northern Rock will no doubt continue to rumble on. It is ironic that the queues of depositors outside the bank's branches wanting their money back, started only after the Bank of England had announced massive liquidity support which made the depositors' money safer than it had been for weeks.

The FSA, some say, should have seen the problem coming, and the FSA itself has accepted that its supervision might have been better than it was. But frankly I don't know of anyone who saw the problem coming in the way that it did, and I don't see how one can expect the regulator to foresee what happened when management didn't. Regulators set minimum standards that reduce the risk of banks getting into trouble, but they cannot guarantee that banks will never fail. They do not actually run the banks, and there is a real danger that the financial system would be throttled if that was what was expected of them.

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

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

**The Future**

There are, certainly, important lessons to be learned from all of this. As far as the authorities nationally and across the wider international financial community are concerned, the need is for greater transparency in our increasingly sophisticated and integrated financial system. That may well involve greater co-ordination between regulators of different parts of the financial services industry in some countries, and greater cross-border co-ordination between them. The approach to liquidity risk management in particular also needs to be reconsidered. Regulators already set minimum liquidity standards, typically requiring banks to hold sufficient liquidity to meet potential liabilities for a period ahead. But, in measuring that liquidity, so-called 'marketable assets' are regarded as immediately available cash (the assumption being that cash would always be available to banks wishing to borrow against them or to sell them). The depositor protection regime also needs to be reviewed. There may well be a case on social as well as financial stability grounds for increasing the size of the deposit protected and perhaps for accelerating the compensation process. But there would be a point at which depositors would simply place their deposits with whoever paid the highest rate of interest, with more prudent depositors effectively being left to pick up the tab in the event of a failure elsewhere.

The debate on all of these issues, and others thrown up by the crisis, is already under way, both at the national level and within the relevant international organisations. Here in the UK, for example, there have been documents from both the FSA and the Treasury inviting comments from the markets. I hope that we don't rush to over-hasty conclusions on all of this, because there is no doubt that the financial world will itself be changing.

The very different, but also very sad, case of Barings, brought down by a rogue trader in Singapore, always comes to mind with its lessons. I recall in particular that for months afterwards senior bankers from all around the world said to me: 'Eddie, there but for the grace of God, go I!' They then sent off auditors and inspectors to their branches and subsidiaries to ensure that they had effective controls in place, and that those controls were being observed, so that they could rely upon the figures reported to them, whether profits or losses. It did more good in terms of the financial system as a whole than anything the authorities could themselves have done. And, ugly and painful as events since last summer have been and will probably continue to be for a while, the market itself will be looking very closely at the lessons to be learned for their own businesses.

The big question now is what impact will the financial turbulence have upon the future evolution of the macro-economy? What will be the knock-on effects? I don't pretend to know the answer to that question with any great confidence. I sometimes wonder whether anyone who does claim to know the answer really understands the question.

There's no doubt that the financial developments discussed here, which are producing a pronounced and necessary re-pricing of risk with a tightening of credit (notably to the household sector but also more generally in terms of leverage), will contribute to a slowdown in the rate of growth of demand. Up to a point that is not necessarily a bad thing in that it should contribute to reducing the external and domestic imbalances that we've lived with for some time. The question is essentially one of degree. Will it mean an absolute decline in demand and negative growth, at least for a while in some countries, or will the slowdown be more modest?

There is reason to be hopeful that the central banks are now more on top of the liquidity problem and the financial storm will gradually blow itself out. The re-pricing of risk is now under way; and many of the banks most severely affected by substantial losses and write-downs have moved aggressively (and very successfully in many cases) to raise new equity. But it may take time before markets generally accept that this is happening.

In the meantime the major industrial countries face a considerable macro-economic policy dilemma. The slowdown in demand growth associated with financial turbulence is currently being compounded by the increase in inflation stemming from the rise in world oil and energy, food and commodity prices. As demand growth slows so too should these inflationary pressures but that too will take time. In the meantime inflation is likely to remain above target in the UK and the Eurozone, and higher in the US, than I am sure they would ideally like to see. That carries the risk that inflationary expectations, which have generally been subdued in recent years, may escalate, affecting economic behaviour.

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