A PROSPEROUS NEW YEAR?

Politeia's New Year Message

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Foreword

For many months now the Prime Minister has explained Britain's economic difficulties as the result of global forces and events in the US. We are led to believe that the problems at home come from the US and the international financial system: the collapse of banks, businesses and the housing market and the sub-prime and credit crises.

But, the reality is of a different order. Not only is Britain amongst the countries worst placed to meet the problems. But, domestic mismanagement has fuelled both the international forces and the difficulties at home. Norman Lamont, the UK's Chancellor of the Exchequer between 1990 and 1993, and Vito Tanzi, the IMF's Fiscal Affairs Director between 1981 and 2000, show where the failures are part of the wider problem. They consider the causes of the crisis and the response so far, explaining what ought to be done.

The crisis, they say, is linked to other problems which have been fuelled by governments' failings: those in the regulatory system when the financial markets were becoming more complex, the current account imbalance, the levels of consumption and the housing boom. At the same time governments' accumulation of fiscal imbalances has gone hand in hand with fiscal accounts which ignored future liabilities and relied on tricks to hide growing problems.

On all counts the UK Government must plead guilty: from increasing public debt and spending to unsustainable levels and hiding their true nature (with a worrying reliance on 'off balance sheet' accounting), to failing effectively to regulate the financial system or make it understandable. Here Labour's model for, and expansion of, regulation was both inept and wide of the mark. The boom in the housing market, followed by its downturn and the impact on the banking sector, is another case in point. Besides, the artificially low interest rates may have been one of the consequences of Gordon Brown's remit to the Bank of England where house prices were excluded from the inflation index.

And now? What of the Government's package of fiscal stimuli? Lord Lamont and Professor Tanzi are sceptical. There is little evidence that such policy has worked in the past; in the case of the Great Depression, it may have made it worse. Besides there is a serious danger that too much reliance on fiscal tools will turn a financial crisis into a far more difficult and damaging fiscal one.

What therefore is now needed? The first priority must be to strengthen the banking system and allow the credit markets to work. Regulatory reform is both urgent and vital to increase transparency and remove perverse incentives. Here the proposals for regulatory reform set out by Professor Tanzi should be taken to heart. Once the immediate crisis has passed, the size and scope of government must be curbed. Britain, says Lamont, has lost the gains of the Thatcher revolution and must restore competitiveness.

Indeed, far from the market economy being to 'blame' for the current crisis, the problem is of another order: that of the failure of those in charge. The crisis owes much, says Professor Tanzi, to the failure of our policy- makers to make the right policy, regulate adequately and referee.

Sheila Lawlor,
Director,
Politeia

Norman Lamont*

Why are we where we are? The current situation looks likely to be the most serious financial and economic crisis of my lifetime. Britain, at the time of writing, is not yet officially in recession but all the signs are that we face a protracted period of negative and/or low growth. This situation is different from previous recessions in that on top of a cyclical downturn there is a banking crisis. But it is important to recognise there was going to be a cyclical downturn—an old fashioned boom and bust—even without the problems in the banking sector.

How did we get into this situation? Firstly, in the UK we have had an unsustainable boom in house prices. It was predictable that we would face quite a sharp correction in the housing market. But it is the downturn in the housing market here and in the US that caused the problems in the banking sector. Until the housing markets on both sides of the Atlantic stabilise, the problems in banking and the wider economy will continue.

We have also had a period during which interest rates in the US and probably also in the UK were too low. In the US official rates were held below 2 per cent for a long period. In the UK Mr Brown, when giving the Bank of England independence, chose to target a very narrow definition of consumer inflation that excluded housing costs. I don't say that would have made all the difference, but it certainly made some difference.

When interest rates were artificially low, investors have chased yield through more and more exotic securities. The credit and housing bubble coincided with a period of radical innovation in the financial sector. I do not say that all that innovation was bad; and features like securitisation are here to stay. One wouldn't wish to disinvent the Internet simply because there was a high-tech bubble.

What needs to be done? The first important thing to be done was to get interest rates down and that has now happened both in the US and the UK. But that by itself will not be sufficient.

What else? I remain sceptical about the effectiveness of very large fiscal packages. It seems to me there are few examples in history of fiscal stimuli that have been unambiguously effective. Of course the situation will vary from country to country and so too will the ability of countries to afford to expand their budget deficits further.

Rather than chucking money over the wall, it seems to me that governments ought to concentrate their resources on getting credit markets to work properly. Strengthening the banking system is the most important task. The banks have been re-capitalised in the UK and many other countries. But it is possible that even more will be required when a second wave of bad debts caused by the recession hits the banking sector. Credit is going to be difficult to obtain, whether for households or corporations at least until 2010. In that situation, governments should consider quantitative easing (increasing money rather than cutting interest rates) as well as purchases of mortgages and other financial securities in the markets. Injecting liquidity may be necessary. But we are in uncharted territory here and there are other dangers as well. In reacting to the present we must ensure that we do not sow the seeds of the next crisis and renewed inflation in three to four years time.

We cannot avoid a painful period of readjustment as the economy de-leverages. There is no way that the reduction in debt and the move of the personal sector from being a net borrower to being in surplus, can happen without a very considerable slow down in the economy.

* Lord Lamont of Lerwick was Chancellor of the Exchequer from 1990 to 1993.

Britain is likely to be one of the worst affected countries. Not only does almost every weakness of the US exist here, they do so to a larger extent — with greater personal and mortgage indebtedness.

The public finances are also highly alarming and if sums for the liabilities, e.g. those of the Royal Bank of Scotland, in which the Government has a majority share, are included, we would have an extremely high level of debt to GDP. Probably RBS's borrowing should not be included, but even so the UK is moving to levels of borrowing not seen for many years.

This crisis has come after a long period in which the British economy has been losing competitiveness. Public expenditure has risen as a proportion of GDP and likewise taxes. Public sector employment has increased rapidly alongside increased regulation of the private sector. Much of what was achieved in the Thatcher revolution has been undone. What Britain needs is to start all over again and take measures to ensure that when the immediate crisis is over, we can, once more, be on a long term path to greater competiveness.

Vito Tanzi[*]

For close observers of the global economic scene in recent years the financial crisis of 2008 should not have been a total surprise even though its intensity and global scope might have been. Over recent years the world had witnessed:

(a) huge, growing, and clearly unsustainable, current account imbalances which saw the richest country (the United States) running negative saving rates and borrowing huge amounts from much poorer countries (including China) to sustain its consumption, its fiscal deficits, and its excessive investment in housing;
(b) growing shares of countries' national incomes going to those engaged in financial activities, that is to 'middlemen' between savers and investors who were compensated handsomely for, presumably, 'creating value' in the economy. In 2007, the 25 best paid hedge fund managers in the USA received total combined incomes from their activities higher than the 30 millions inhabitants of Kenya;
(c) growing complexity in the financial market, that made it difficult to allocate and assess risks correctly; and growing reliance on little understood, opaque and largely unregulated financial operations or instruments, such as 'debt default swaps', 'feeder funds', and others;
(d) regulators who were asleep at the wheels or, worse, who even worked for the interests of the regulated;
(e) growing bubbles in the housing and other markets with accommodating monetary policy;
(f) fiscal accounts that ignored future liabilities and that relied more and more on financial engineering and other tricks to hide present and future fiscal problems and to present a good face.

We should have paid attention, but did not, to the well-known dictum, attributed to the late Herbert Stein, that 'if something is not sustainable, it will not be'.

To the above list should be added the evidence of growing governance or corruption problems in the financial system, facilitated by its complexity. These problems have partly migrated from government activities, where they used to reside, to financial markets, where they have found a fertile ground. They have contributed to the sub-prime crisis and to episodes such as the recent Madoff 'Ponzi scheme' among others. These ingredients created a brew that would sooner or later explode into a crisis with inevitable and serious consequences for the real economy as it did.

There has been a tendency on the part of many observers to blame the market economy for the current crisis. However, such observers have ignored the failure of policy makers and regulators in performing their essential functions of policy making, regulating and refereeing. A football game without a capable and impartial referee is likely to degenerate into chaos. This happened to the global economy.

While the crisis should not have been a surprise, its intensity has been. Past and increasingly frequent financial crises had often been intense but largely local. Think of Sweden in the early 1990s, Mexico in 1995, Southeast Asia in 1997-98, Russia in 1998 and Argentina in 2001-2002. They were all limited geographically. Today's crisis is global and its centre of gravity is the United States and other G-7 countries. However, policy makers**,** who had done little to correct the developments that led to the crisis, must now deal with its consequences. It is vital

[*] Vito Tanzi was Director of Fiscal Affairs at the IMF from 1981 until 2000. His publications include *Public Spending in the 20th Century: A Global Perspective* (Cambridge, 2000) with Ludger Schuknecht and *Death of an Illusion? Decline and Fall of High Tax Economies* (Politeia, 2006).

that they prove to be more capable this time. Given the strong and understandable urge for them to show that they are in charge and are 'doing something', they would not like to be seen as sitting idle. As a result they have fallen back on the traditional tools of policy.

Their first reaction has been to ease dramatically monetary policy, by reducing interest rates that central banks control. In some countries, including the United States, these rates are approaching zero, as they did in Japan in the 1990s. But, as in Japan, this does not seem so far to be helping private borrowers to get cheap credit because the problem is not one of lack of liquidity or even lack of demand for credit but one of trust in the financial system. Without that trust, there will be much less lending regardless of the level of the rates. Furthermore, the reductions in interest rates reduce the incomes of older individuals who generally have larger financial assets and higher propensities to consume.

The second reaction has been to use the traditional Keynesian recipe, of increasing public spending or, as in the UK, of cutting taxes, in situations of economic slowdown. This had already been tried earlier this year in the United States but had not worked. The view now is that, if the medicine did not have its effect on the patient the first time, the dosage must be increased, and the more of that medicine, the better. Nobody is asking whether this might not be the right medicine. There is also talk of a coordinated fiscal expansion by countries, regardless of their fiscal situation. There are several problems with this policy. First, it starts from situations in which the fiscal accounts were already a source of concern before the crisis in many countries, including the United States and the UK. These concerns will inevitably grow when the fiscal deficits and the public debts reach large shares of GDP, as they are expected to do. Larger public debts will have to be serviced in the future when the needs for higher public spending (for infrastructure, health, pensions, and so on) are expected to grow and when interest rates may not be so low. Second, fiscal deficits need to be financed now, thus diverting financial and real resources from potential private uses. This could be a problem especially in countries where private saving is very low, as in the USA. Third, the large public spending will inevitably create and increase inefficiencies in the use of resources, as happened in Japan in the 1990s. The urgency to spend is likely to take precedence over the need to spend well as is happening in the USA with the bailout money. Much of the additional spending will be used to allow inefficient activities to continue to operate as before. In fact the main objective of the fiscal expansion will be to keep in operation many inefficient or over-expanded activities that in the first place led to the crisis. Just think of the money being used to keep carmakers in existence or to allow the housing sector to continue to produce more houses than people want to buy. Fourth, whatever effect the fiscal expansion might have, that effect is likely not to be felt for some time. Finally, the Keynesian recipe works best when the problem is simply one of falling demand, because new technologies are not available for new investments, or because consumers have become more pessimistic, for whatever reasons. It was not intended to help an economy when the problems are largely structural as they are now in the financial market.

The end of the Great Depression is at times mentioned to justify the impact of a fiscal expansion; and President Roosevelt's New Deal is credited as the policy that ended the Depression in the USA. The truth is that, although GDP started growing again in 1934, from the very low base it had reached after 1929, real GDP in 1938 was still at the same level as in 1929. The fiscal deficit grew from 4 per cent of GDP in 1932, the last year before Roosevelt, to 5.9 per cent of GDP in 1934, before it started declining again. The Depression ended when preparation for the Second World War started and when Roosevelt's structural and institutional reforms introduced with the New Deal started to have an effect. Roosevelt's role was important because he introduced many reforms that would be useful for a modern economy in future years—as argued by Robert J. Shiller in the *The Subprime Solution* (2008)—and because he provided assistance to those most directly affected by the Depression, through work programs and other related programs. Also the Japanese experiment with Keynesian fiscal policy in the 1990s is not comforting. A huge fiscal expansion, that increased enormously the public debt, had no effect on the real economy because the problems were largely structural.

An important point to understand is that the Great Depression became 'Great' because of the **wrong policies** that governments followed (protectionism, etc.) and not because of governments' inaction. Without those wrong policies the Depression would likely have been less 'Great' and less long. At times mistakes of **commission** may have more serious consequences than mistakes of **omission**. We should be mindful of the Hippocratic Oath for physicians: to make sure, when prescribing a cure, that the cure does not make the patient worse. Let us hope that today's governments will keep that Oath in mind. We will find out only later if they have.

At this time some easing of monetary policy is appropriate, together with letting automatic fiscal stabilizers do their full work. It would also be reasonable to accelerate work on already planned infrastructure projects, or on already designed and needed infrastructure. That would anticipate the time when the projects would be created. Much of the attention should go toward correcting wrong incentives and misguided regulatory policies that existed before the crisis and still exist in the financial sector. In that context the functions of the regulatory agencies should be carefully analyzed as suggested in my recent Politeia pamphlet.[*]

What should not be done is attempt, through fiscal and monetary policies, to bring the economy back to the status that existed before the crisis and which prompted the crisis in the first place. Relying too much on fiscal tools may turn a financial crisis into a fiscal crisis. But fiscal crises are more difficult to correct and last longer with more damaging consequences on economic growth.

Meanwhile, once the crisis is over, government must once again streamline its role, pay more attention to its fundamental functions curbing the less fundamental activities it has assumed in recent decades. Without such streamlining and attention, the fiscal costs of the crisis may condemn the economies to a long period of little or no growth.

[*] Vito Tanzi, *Regulating for the New Economic Order: The Good, the Bad and the Damaging*, Politeia, 2008. A summary of the proposal can be found in the Appendix.

The Principles and Practice of Effective Legislation

Summary: In *Regulating for the New Economic Order: The Good, the Bad and the Damaging* , Vito Tanzi sets out the principles to guide effective regulation and warns that the wrong kind of regulation can do more harm than good. The study shows that the consequences of regulation can be good or bad and the Government must analyse potential impact before introducing fresh measures. Economists, it explains, are divided about the impact of regulation on economic growth and prosperity. Some regulations are needed—for example to create full transparency, to regulate cartels, to tackle the complexity of modern institutions (and 'fat cats'), and to prevent harmful developments. But others can cause serious difficulties, especially when those in charge make the 'nirvana error'—confusing what happens in reality with a non-existent ideal system regulated and supervised by individuals imagined to have 'the wisdom of Solomon, the knowledge stored by Google and the honesty of saints'. Problems often arise when the regulators take charge; or have cosy relations with the regulated (often leading to a culture of 'cover up and complacency'); or have too much discretion in enforcement; or do not do their job fairly and efficiently, as well as when the regulations are simply wrong.

The study explains that, in market-oriented economies, regulations can be used for the same goals of economic policy as tax and spending: the allocation of resources, redistribution of income and stabilisation of the economy: 'Making them less rigid should have a positive impact on economic activity. Making them more rigid [could] have the opposite effect'.

Governments should be guided by clear principles:

- Any fresh regulation should be undertaken in moderation with carefully chosen objectives.
- Regulations rushed in after a crisis can be too rigid and burdensome.
- Regulations should always be based on clear and valid principles that justify the rules.

Governments should ensure that new regulations must:

- Be few and not so rigid as to stifle innovation.
- Promote as much transparency as possible.
- Be written in the clearest way possible so that the average citizen can understand them. And there should be no room for the regulated, or for government officials who administer regulations, to exploit ambiguities.
- Be tested for clarity before being adopted.

In particular, the Government should:

- Introduce a specific regulatory budget for regulations affecting economic behaviour (and a full compilation of all the rules in existence).
- Review all aspects of the regulatory budget regularly—at least every ten years—amending it as necessary.
- See that all regulations are discussed and approved by national parliaments, and not just by the executive.
- Subject new regulations to rigorous cost benefit analyses.
- Make the existing regulations as clear as possible to the general public and not just to experts, reducing misinterpretations and eliminating ambiguities.

Regulating for the New Economic Order: The Good, the Bad and the Damaging by Vito Tanzi is available online from Politeia (www.politeia.co.uk). For an E-version please follow link http://www.politeia.co.uk//Portals/0/RegulatingfortheNewEconomicOrder.pdf Hard copies are available to journalists on request from secretary@politeia.co.uk

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