Michael Bordo
Harold James

Crises Managed

Monetary and Fiscal Frameworks for the Future

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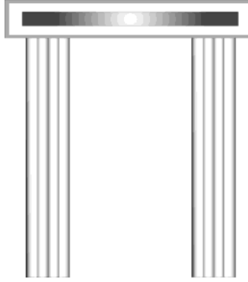

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I
The Financial Crisis – A Legacy of Doubt

The aftermath of the financial crisis, now often called the Great Recession, has raised many questions about how policy responded to the crisis, and larger and fundamental issues about the role of the economy in a well-developed, healthy society. In particular, it has led to a debate about fiscal policy, about the sustainability of deficits and debt, and about the use of inflationary monetary policy for reducing both public and private sector indebtedness.

These discussions are polemical, acute, and significant in the UK, where inflation is accelerating significantly. The effectiveness of policy set by an independent central bank is challenged, and the resistance to fiscal consolidation is rising. Larry Summers sees the British debate about what he terms a paradoxical 'expansionary fiscal contraction' as a kind of doomed experiment, and thinks that the rest of the world should learn a simple lesson that budgetary orthodoxy is dangerous and destructive. Economists are fiercely polarized. Even the mild-mannered Archbishop of Canterbury has intervened to condemn the 'anxiety and anger' produced by fiscal retrenchment.

Very often a crisis - especially a very severe crisis - can lead to an opportunity to learn. The lessons can be twofold. First, the problem should be identified. Second, an institutionally workable measure to correct it must be found.

In the past, crises have induced a productive and successful learning process. In the case of trade policy during the Great Depression, a spiral of trade protection measures was used to combat monetary deflation. The political decisions trade quotas and tariff restrictions were a result of logrolling in the legislature (i.e. the cumulation of particular and dysfunctional local interests), as well as from a general demand for political action. At the time responsibility for trade measures was transferred from the U.S. Congress to the President, partly prompted by the analysis of congressional politics provided by the political scientist E.E. Schattschneider.[1] Second, the Great Depression also produced a new discussion of monetary policy. Our understanding of monetary policy has improved over the past forty years: we understand that monetary policy can produce short-term stimuli that appeal to politicians facing elections; these short-term stimuli have no effect on the overall course of development but do have a substantial effect on prices. The result is a powerful consensus that central banks should be insulated from political pressures.

[1] E. E. Schattschneider, *Politics, Pressures and the Tariff. A study of free private enterprise in pressure politics, as shown in the 1929-1930 revision of the tariff*, New York, Prentice-Hall, 1935.

II
Continuing Instability

In the course of the financial crisis, the framework for policy has become more uncertain, but without, it seems, lessons being learned.

Conventional agreement about the causes of the post-2007 financial crisis rely on some combination of the following five sources of instability with different weight given to different elements or the relevance of one or other of the points denied depending on a range of prior assumptions. These include:

- The peculiarities of the U.S. real-estate market (government incentives for increased house ownership; imprudent lending).
- Wrong incentives in financial institutions leading to the assumption of excessive risk (partly induced by the logic of too big to fail); the public sector then had to absorb the contingent liabilities built up in the financial sector.
- Global imbalances, with long-term current account deficits in some countries (the U.S., U.K., Australia, Spain, Ireland) and long-term surpluses in others (China and other rapidly growing Asian economies, Gulf oil producers).
- Loose monetary policy, especially in the U.S.
- The fiscal consequences of major banking problems prompting problems of debt unsustainability and having the capacity to destabilize the banking sector.
- A sixth cause, peculiar to the European problem, should be added: the relatively long run divergence of relative labour costs relative to productivity to developments in a single monetary area, a problem that antedated the financial crisis, but contributes greatly to the problems encountered by the Eurozone.

The first of these, peculiarities in the real estate market, is probably a precipitant, in that the total amount of sub-prime mortgages by itself is not sufficiently large to trigger a global financial crisis of the magnitude witnessed since 2007.

With the exception of the first, however, the amazing feature - and an indictment of current ability to learn - is that all of these problems are still around. Nonetheless, there is some movement towards financial sector reform, with a gradual consensus-

building around sliding or incremental capital adequacy rules, with bigger buffers required for large, inter-connected and systemically important institutions

However, the continuing problems include:

- Global imbalances were immediately reduced in the course of the initial crisis, with the U.S. adjusting its deficit relatively rapidly; but they are emerging again. The non-disappearance of imbalances may be something of a blessing. Indeed, a complete reversal of imbalances, as occurred in the 1930s, when capital returned to the creditor countries, would probably have created a new version of the Great Depression.
- Major countries are maintaining very low interest rates, with a widespread suspicion that this is part of a strategy of currency depreciation by the United States ('currency wars' in the phrase of the Brazilian Finance Minister), that loose monetary policy is fuelling commodity and food prices rises (and social unrest in many emerging countries, including those that are perceived to be the major competitors of the U.S: i.e. China). There is also a widely held belief that any tightening of policy will produce immediate problems, which will immediately damage the prospects for fiscal sustainability of many governments with high debt ratios (the U.S. and Japan, as well as some European countries).
- We do not know how to handle the fiscal issues posed by the financial crisis. Doubts about the sustainability of government debt produce sudden surges of interest rates, as risk premia rise dramatically with perceptions of the likelihood of default. Such rises do not take place in a linear way, but occur with great suddenness. The UK is exceptional in a European comparison at the moment; despite its poor debt and fiscal position is still nevertheless sustaining low costs of government debt service. That position would be threatened by hints of new fiscal imprudence or by the abandonment of plans for long-term debt consolidation and reduction. In those circumstances, the additional costs of debt service easily outweigh any gains that might come from some measure of fiscal relaxation.

Fiscal uncertainty is affecting all major industrial countries. In the United States, it produces political paralysis. In the EU, disputes about how to do rescues of over-indebted high deficit countries - in particular on how to distribute the costs - threaten the single European currency and indeed the whole process of integration. Some analysts believe that Japan is better off, but the very high level of government debt (in large part the consequence of an older banking and financial sector crisis of the 1990s that was not adequately resolved) threatens to be unsustainable if interest rates rise

from extraordinarily low levels. And China, which was widely seen as the locomotive of global growth in the financial crisis in 2007-8, is now witnessing a surge of speculation that it too might be threatened by government default, and money is flowing into the insurance offered by credit default swaps.

So while we understand quite well what may have produced the financial crisis, we are pretty helpless about actually drawing useable lessons. In particular, the prospects of large-scale banking or financial sector failures and large-scale public sector insolvencies continue to pose a serious threat. The two sets of problems are intrinsically inter-connected in that major banking sector difficulties require public bailouts, while government insolvencies threaten banks as well as other institutions that hold large amounts of government debt.

Before the crisis, monetary, financial sector, and fiscal policy were all carefully separated in institutional terms, with particular goals or objectives. Monetary policy was concerned with price stability, financial policy was fundamentally preventive and aimed to avoid banking or financial sector breakdowns, and only fiscal policy seemed to offer a chance for political activity: for what is seen to be a general or public good, and for the realization of objectives formulated as part of a political process. But now all of these policy domains have become highly, and dangerously, politicized.

III
Monetary Policy as a Substitute for Fiscal Policy?

Before 2008, there was a general consensus that central banks were primarily concerned with price stability and with monetary policy. This was important given that money plays a special role in economic life as it is a store of value and a unit of account.

Why is this? Markets have been distorted by inappropriate price signals following from mistaken monetary policy that make impossible a rational basis for long-term decision making. A rising general level of prices (inflation) increases incentives to consume and spend now, while penalizing longer-term investments in the future. Inflations of the kind that occurred in the 1970s distort market signals, and have particularly destructive effects in financial markets because they destroy the ability to make long-term calculations. A highly inflationary environment such as occurred in Germany in the 1920s or more recently in Yugoslavia, Russia, Argentina and Zimbabwe, encourages living for the moment, without a thought of future activity and future generations and ultimately kills economic activity. Unanticipated inflation redistributes income and wealth from creditors to debtors. The belief that it is possible to use politics to affect the monetary process and hence also the distribution of resources increases the stakes in political conflicts, and generally produces political instability.

There is a political symmetry between the operation of inflations and deflations. If imperfectly anticipated inflations are a tax on creditors and a subsidy to debtors, unanticipated deflations subsidize creditors and tax debtors. Both have redistributive consequences and both increase to an unsustainable point the pressures on the political process.

We know, for instance, that falling general level of prices (deflation) increases debt burdens, and acts as a constraint on business activity and innovation because this was the malaise of many economies in the 1930s. Deflation pushes businesses and individuals into bankruptcy, makes credit inaccessible, and blocks the realization of new and innovative possibilities. The effects of deflation are especially severe if the deflation is unanticipated, and if wages and prices are inflexible. Unanticipated deflations have major redistributive consequences, in which debtors are highly burdened, and creditors claim more assets because in practice rigid prices and wages will produce an underutilization of resources.

In a highly deflationary environment, few potential entrepreneurs will be willing or able do anything now, but will wait for a better future. In prompting current under-activity, however, the possibilities of a better future are also diminished. In the 1930s Great Depression, monetary policy mismanagement (leading to deflation) produced bank panics and financial sector instability; a powerful tradition of economic analysis suggests that for the U.S. and some other countries, the banking problems were the consequence of gold-standard induced price deflation.[2]

Severe deflations also lead to a politicization of economic decision-making, and to greater political instability; as do severe inflations, when powerful interest groups want to be close to the source of money and credit (usually the central bank). Here too there is an effective symmetry between monetary disorders, though in the twentieth century inflationary problems generally proved to be more common than deflationary ones.[3]

A long-term framework for economic and social sustainability, and for the transmission of chances and opportunities from one generation to the next, thus depends on a basic commitment to monetary stability.

After 2008, the financial crisis led to central banks involvement in the response to the financial sector's stability problems as banks were threatened by insolvency. So-called unconventional monetary policy, in which central banks lent against a much broader range of assets, brought them into the politically sensitive areas of credit allocation and credit policy. They had to make choices about what types of security to take into their portfolio: mortgages, student loans, automobile credits. In addition, when there is some possibility of loss, there is an implicit subsidy involved. These are fundamentally fiscal issues. As a result of the involvement and decisions taken monetary institutions began to be expected to do fundamentally fiscal things.

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[2] Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States*, Princeton N.J., Princeton University Press, 1963; Michael D. Bordo, Ehsan U. Choudhri, Anna J. Schwartz, 'Could Stable Money Have Averted the Great Contraction?' *Economic Inquiry* 33/3, 1995, 484-505; Ben S. Bernanke and Harold James , 'The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison,' in R. Glenn Hubbard*, Financial Markets and Financial Crises*, Chicago: University of Chicago Press for NBER, 1991.

[3] However, we need to distinguish between good (productivity driven) and bad deflation (collapsing aggregate demand). The Great Depression of the 1930s was an example of a bad deflation, the low deflation and significant growth in the U.S. in the 1870s and 1880s an example of good deflation (Michael D. Bordo and Andrew Filardo, 'Deflation and Monetary Policy in Historical Perspective', *Economic Policy*, 20/44, 2005, 799-844). In addition expected deflation equal to the real interest rate produces the 'optimum quantity of money' and the most efficient allocation of resources in a money economy (Milton Friedman, 'The Optimum Quantity of Money,'chapter 1 in Milton Friedman (ed.*), The Optimum Quantity of Money and other Essays*, Chicago: Aldine Pub. Co., 1969.

The more such quasi-fiscal policy is made by central banks, the more a sustainable monetary policy is undermined. The effects are already quite visible. The decision-making bodies, the UK Monetary Policy Committee, or the US Federal Reserve Board of Governors (responsible for approving securities purchases 'in unusual or exigent circumstances' under the 1932 Emergency Relief and Construction Act, Section 13/3, or (to a lesser extent) the ECB Council have become arenas where high profile quasi-political figures with reputations as hawks and doves slug it out. This is a long way from the supposed autonomous operation of the central banks that are only involved in setting monetary policy in accordance with the sole target of price stability.

The intellectual shift towards central bank independence, which characterized the late twentieth century, was only possible on the assumption that there was a really clear rule or principle that the central bank should follow. When that rule or principle became muddied, and discretion in policy making returned, the case for central bank independence began to look more problematical. The pendulum is swinging back, toward a nationalized Bank of England, a more accountable Federal Reserve, and an ECB that answers to the people of Europe.

This move to greater political influence is reminiscent of the trend in the interwar period when trade policy became politicized and nationalized. The primary lever that is used in the critique of central banks is a new kind of financial nationalism. The Fed's policy of the early 2000s is reinterpreted as having been largely to the advantage of China - in the same way as in the 1930s the accusation was that the Fed had helped Europeans unfairly.

The criticism is even more acute in regard to the handling of the financial crisis. Banks that are under some measure of government control because of crisis recapitalization or other support - whether in Britain, the U.S. or Europe - are pressed to cut back their foreign lending. Central bank swaps that seem to help foreign banks are a source of embarrassment. What is most painful about the bank bailouts in the September 2008 crisis is that they involved the support of foreign institutions. In particular the rescue of AIG is attacked because the principal beneficiaries apart from Goldman Sachs were the big European investment banks, Credit Lyonnais, Deutsche Bank, or UBS. The post-crisis assumption is that something that helps other countries must be bad for one's own country. In short international financial cooperation is unpatriotic and treacherous.

The motives behind such political interventions against the central banks are not difficult to detect. The idea of intensified political control, especially by parliaments, opens up central banks and the financial community in general to political pressure.

That strengthens the parliamentarians. Monetary policy is seen as offering free lunch, rather than as providing a reliable measure. They can decide where credit should flow: to their constituents, rather than to the clientele of an internationalized banking community. The parliamentarians in short see a zero-sum distributional game when they think about credit allocation rather than monetary policy goals. The result has been to attempt to restrict money policy to a national framework, and to produce the equivalent of depression-era protectionism, when the U.S. Trade Act of 1930 (the Smoot-Hawley Tariff Act) inspired a wave of retaliatory trade measures and pushed world trade into a spiral of decline.

IV
The Fiscal System: Problems and Weaknesses

Fiscal policy traditionally has been much more about the redistribution of resources, and in that sense it is properly political.

Nobody - or at least very few - would deny that there is some need for government activity in the regulation and management of economic life. In particular, governments can solve some collective action problems that arise from specific market failures, when some particular conduct produces costs or disadvantages for others. They provide collective goods, in particular internal and external security and basic infrastructure. The institutions that make free exchange possible - the definition and enforcement of property rights, the arbitration of disputes, and the rule of law in general - depend on government. Governments thus have a fundamental and indispensable role to play in ensuring the proper, competitive and free functioning of markets.

That operation also demands as a prerequisite sustainability, and that depends on perceptions of the legitimacy and fairness of the social order. There is thus a legitimate demand that fiscal policy should promote some sort of social justice. It must offer a safety net, when other - better - mechanisms that should produce social cohesion and solidarity (such as greater levels of entrepreneurship, raised skill levels) for some reason are not effective. Indeed failure to do so can produce bad and destabilizing consequences, and dramatic market failures. One of the contributing causes of the financial crisis lay in the perception that widespread access to credit and borrowing could offer a compensation for poor wage growth and falling real incomes. The credit boom - one that was ultimately unsustainable - was thus a compensation for inadequate productivity growth, both for people (above all in the U.S.) and indeed for whole countries (above all in Mediterranean Europe).

Dealing with market failures might appear to be a particularly urgent function of government in situations in which many of the preconditions that might lead to the development of efficient markets are absent. As more complex and more sophisticated institutions develop, and as society becomes more complex, the necessary scope for government might be expected to be reduced. In practice, however, governments have become more and more active, and also more and more complex.

Government action is constantly expanded because there is a sense that existing control provisions are inadequate and should consequently be extended. When government starts to be active in a particular field of endeavour, that action requires new legal provisions. The creation of such a framework by itself often means that it is more difficult for the private sector to be active in the same area; and it establishes an assumption that government has a proper role here. Such calculations contribute to the ratchet effect that characterizes a great deal of modern government activity.

One particular example has been frequently highlighted in recent discussions. Distortions of the U.S. housing market played a prominent part in the origins of the financial crisis. An increased share of mortgage lending came from government-sponsored enterprises, notably Fannie Mae and Freddie Mac. (That share fell slightly in the Great Recession in 2008-9, but has since increased again.)[4] The Community Reinvestment Act required private lenders to expand their lending to borrowers below the median income levels in the areas in which they were active. There are also more general distortions that follow from the particular fiscal treatment of favoured activities, in particular house purchase through mortgage tax relief. Tax calculations prompted a higher level of engagement in housing than would otherwise have been undertaken. The result of the extension of government subsidies and regulations produced a complex and large-scale system of distorted incentives that affect and alter market behaviour.

One of the features of complex tax deductions is that they create a demand both for ever more complexity and for greater access to special treatment. This is a powerful argument against the often-made attempt to use tax policy to promote particular kinds of activity. A simplified tax system will reduce the extent of lobbying to produce new distortions.

Furthermore, public programs establish powerful and politically influential coalitions and lobby groups. The operation of legislative assemblies in framing budgetary laws often generates the inclusion of additional spending authority that initially seems of minimal overall cost to the society at large but of great benefit to individual legislators and their constituents. The building up of such authorizations of expenditure in the end may however become very costly when all are aggregated together. There is an analogy between the build-up of fiscal claims with the way congressional discussion of trade policy in the interwar years led to the addition of a multitude of small measures of protection that in the aggregate became costly and destructive.[5]

[4] Federal Housing Finance Agency Conservator's Report on the Enterprises' Financial Performance Second Quarter 2010; http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf

[5] Douglas Irwin, *Peddling Protectionism: Smoot-Hawley and the Great Depression,* Princeton, Princeton University Press, 2011.

Sometimes government may spend rather aimlessly simply in the hope of achieving an aggregate stimulus that may promise a political pay-off. It is hard to see how this kind of spending is constructive. In the words of a recently leaked 2006 UK cabinet memorandum, 'We've spent all this money, but what have we got for it?'[6]

Finally, many programs are established with an initially modest cost but later expand, perhaps as the result of the availability of new technology (for instance in medical provision) or because of the expansion of recipient categories because of demographic change (as most notably in social security provision). Both developments mean the opening up of large funding gaps.

There is in consequence a tendency inherent in the operation of many legislatures to accept a build-up of expenditure that cannot be financed in the longer term, and thus imposes high costs and limits on the actions and choices of subsequent generations. While it is clear that there are circumstances in which unanticipated economic or financial shocks may demand a temporary increase in the extent of government activity in order to stabilize both economic activity and economic expectations, and that such an increase may be expected to raise government debt, the long term stabilization of expectations also requires that such increases in expenditure need to be funded. These are circumstances in which appropriate government action may contribute to the building of confidence and trust. Confidence and trust are important factors in generating successful economic outcomes; their absence leads to sub-optimal equilibria. In the long term, however, government debt that increases at a faster rate than the overall growth of the economy will eventually become unsustainable, and will erode confidence and sap trust.

Different societies will choose different levels of government activity. It is possible to identify some societies (mostly lower income countries) in which the small size of government leaves basic tasks unprovided, in which there is inadequate security, enforcement of law, or infrastructure. People need to provide privately for their own security, and are constantly mistrustful of others. The absence of an effective rule of law it impossible for anything that we might identify as society to exist. It is also possible to identify societies where the size of government has become so large as to crowd out the room for individual action and initiative. In Sweden in the 1970s and 80s the average marginal tax rate was close to 90% and the share of government in GDP was close to 60%. A government that is too big undermines society just as surely as a government that is too small.

[6] January 2006 cabinet document: http://www.telegraph.co.uk/news/politics/labour/8569367/Labour-spending-Gordon-Brown-and-Ed-Balls-ignored-warnings-and-wasted-billions.html

The creation of new tasks for government in response to a build-up of political lobbying often means that some of the most basic tasks of government are left undone so that, for instance, complex welfare systems exist alongside inadequate or antiquated infrastructure. Some economists have tried to identify a maximum sustainable level of government activity as 30 percent of GDP: such precision is quite hard to justify on the basis of general principles.[7] For some societies, higher rates may be sustained for long periods of time if they are adequately funded; other societies would find even a 30 percent level corrosive. The historic concerns of American society in limiting government activism may mean that a preference for a lower level fits most easily with U.S. political traditions.

Markets have been distorted more frequently by excessive claims than by inadequate expectations about what governments can and should do. Such over-optimistic claims about the effectiveness of government often produce a vicious cycle, in that such claims build up expectations of positive outcomes; and when they fail to achieve their aims, the failure is blamed on the partiality or the inadequate extent of government action, and there is in consequence an even more vocal call for government action. The state's over-extension tends constantly to excite larger demands for how the state might determine or alter the market process. As a consequence it is expedient to delimit the right or appropriate area for and extent of state activity.

[7] Vito Tanzi and Ludger Schuknecht, *Public spending in the 20th century: a global perspective*, Cambridge, CUP, 2000.

V
Where Next?

The response among industrial countries to the current crisis indicates that the lessons have not yet been adequately learned. Industrial countries like Britain find it difficult to deal with market conditions which do not allow them to rely on continued, or perpetual financial access. Many of the sources of economic instability remain; meanwhile what were previously more distinct areas of policy, monetary, fiscal and financial, now overlap and have been politicised. All industrial countries are finding it hard to grapple with a market situation in which there can be no certain reliance on continued or perpetual cheap funding of government debt. Their current behaviour contrasts with the emerging markets in Asia and elsewhere after the 1997-8 crisis when their governments used the experience of crisis to improve the framework for policy and consolidate fiscal policy.

Industrial countries such as the UK now need a reform program that will induce greater long term stability and include:

1) **A commitment to a reliable monetary order and to an effective institutional framework for ensuring monetary stability**, **preferably through independent central banks. Central Banks' independence should be guaranteed legally** and their goals should include commitment to overall price stability with a sustainable price level or inflation target over the medium term. With a credible system for meeting the long term inflation (price level) target, it is less likely that short term responses to temporary shocks will prompt counter-effective market expectations

2) **Long-term fiscal guidelines and rules to limit the size of government and to exclude long term increases in government debt. A limit should be placed on government deficits over the course of the business cycle.** Such guidelines would allow for a (short term) response to unexpected events. For example, severe recessions and natural disasters. But they would prevent any ad hoc responses to emergencies from becoming permanent policy. Some countries have experimented with variants of balanced budget requirements: that was a German policy initiative in 2009, which Germany is now proposing to extend as an EU-wide approach. Actual experience of such legislative compulsion is rather mixed: the U.S. Gramm-Rudman-Hollings Act of 1985 was briefly effective, but has not been a long-term model, and failed to prevent the rapid reintroduction of complex tax clauses after the major and apparently innovative 1986 U.S. tax simplification.

3) **An explicit, visible and transparent link should be made between public consumption of social goods and the tax revenues needed to pay for them.** The breaking of such links has been responsible for long-term pressures towards fiscal unsustainability.

4) **An independent fiscal council with advisory functions to counter the pressure of interests groups on governments and parliaments.** After the fiscal crises, some European countries instituted such councils: Sweden in 2007, Hungary in 2009, and the United Kingdom's Office for Budget Responsibility in 2010. These have been characterized by a high degree of independence, and a willingness to offer critical assessments of government forecasts and of government policy; but the consequence has also been conflict with the government (the current Hungarian government is trying to replace the fiscal council after receiving a great deal of criticism).[8] The UK OBR is a good beginning, but its role could be extended to encompass a much more far-ranging review of spending commitments and the implications of government policy and programmes for public spending and taxation. A central body for fiscal policy would be analogous to a central authority for trade policy, or an independent central bank's role on monetary policy. For example the recently created US Office of Financial Research has responsibility for collecting data in order to analyse the prospect of systemic financial risk.

   Such a fiscal council would examine fiscal risk: programs whose costs could escalate with increased take up or new demands. Although legislatures and parliaments should decide the objects of policy, in healthcare, education, security, etc., and the overall levels of public expenditure, the fiscal council would evaluate whether money is being spent effectively, it would propose alternative ways to reach the same goals at lower costs Above all, it should evaluate the long term consistency of spending plans. There is a case for going much further than existing Councils, including the OBR.

5) **An extended Council would, as well as examining long-term fiscal sustainability, also have a mandate to examine the balance between costs and outcomes or results in every branch of government activity, including spending on defence, foreign policy, social security, medical care and education**. All are indisputably public goods, but there is a legitimate expectation that public goods should be delivered efficiently.

[8] There is a comprehensive list of fiscal councils and of academic treatments of the proposal in: http://www.economics.ox.ac.uk/members/simon.wren-lewis/fc/fiscal_councils.htm

> The Council should offer both an analysis of long term sustainability and a particular and comprehensive analysis of the cost-effectiveness of all government programs: what they are designed to achieve, whether that is a benefit that can be measured, the likely path of future costs in order to achieve that benefit.

In the sphere of monetary policy, expectations are anchored by a credible and explicit inflation target, which in general is not set by the central bank itself but by the political authority: the desired rate of inflation is a political objective or choice; it is then up to the central bank how to achieve it. The analogy for a new fiscal regime might be an explicit growth and employment target over the long term, which would encourage the private sector activity that might result in that target being achieved.

As in the case of monetary or trade policy reform, action will only come when there is a widespread and deep recognition that something is really broken. It seems to us that we have reached that point: a crisis, to use the original medical sense of the term, is the moment when the disease is either cured or it moves on to a termination fatal for the patient. In the 1980s, a critical breakthrough in the UK was the Medium Term Financial Strategy. What is needed now is a Long Term Financial Strategy, which gives a framework on which decisions can be made by the host of people who make for an innovative society. Once again, the UK might be in the vanguard of change, as it was under Margaret Thatcher, and set a model in the industrial world.

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The 2007 crisis and its aftermath have been followed by recession in many countries. But have the lessons been learned?

In *Crises Managed: Monetary and Fiscal Frameworks for the Future* Michael Bordo and Harold James explain that the problems which led to the crisis continue or have returned. Global imbalances, manipulation of interest rates, loose monetary policy, potential banking failures and public finance insolvencies threaten stability and recovery. Central banks and the financial sector as a whole are under increasing political pressure, and, because monetary and fiscal policy have become politicized, our systems are now less likely to overcome the problems than before. Moreover, high levels of public spending and activity have become the norm, but the evidence is that they cannot be financed in the long term.

The authors propose a series of robust measures for a reliable monetary order, long-term rules for the size of government - and its balance sheets - and an independent fiscal council to counter the ever greater demands of the interest groups to which governments today fall victim. The UK now has the opportunity to lead change, as it did under Margaret Thatcher in the '80s, and set a model for the industrial world.

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