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The Ninth Chintaman Deshmukh Memorial Lecture
given by

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Economic policy approaches - some reflections

I am delighted and very greatly honoured to have been invited by Governor Rangarajan to deliver this Ninth Chintaman Deshmukh Memorial Lecture.

I am delighted because the Governor's invitation provided me with the perfect justification for making my first - and very long overdue - visit to India.

I am honoured by the Governor's invitation because it joins me with such a very distinguished list of previous lecturers in paying tribute to Chintaman Deshmukh, the first Indian Governor of the Reserve Bank. I am honoured particularly to have been invited to deliver my lecture this year - which marks the centenary of Governor Deshmukh's birth.

It was never my privilege to meet Governor Deshmukh - I was still in my cradle when he first became associated with the Reserve Bank in 1939 as Liaison Officer to keep the Government of India in touch with the Bank's affairs; and I was still wearing short trousers when, ten years later, he stepped down as Governor to embark upon new phases in his lifetime career of public service - as Finance Minister and subsequently in education. But, in preparing for my lecture, I have come to know and admire Governor Deshmukh as a man of great intellectual curiosity and insight - a true "renaissance man". He was also apparently a man of considerable wit. In his celebrated Kale lecture on "Central Banking in India" delivered in 1948, he discusses the circumstances of his appointment as Governor of the Reserve Bank - an appointment which, it would seem, was opposed by my own illustrious predecessor, the redoubtable Montagu Norman. Governor Deshmukh comments on the episode in these words:

> "The Government of India were overruled by the Secretary of State and Deshmukh was appointed Governor in the middle of August 1943. So once again went agley the schemes of mice and M.N.."

The wartime and immediate post-war global economic environment within which Governor Deshmukh operated, during the period of his association with the Reserve Bank, was fundamentally different from the global economic environment we are confronted with today; and so, too, were the accepted approaches to economic policy.

At that time, and for much of the intervening period, while there were marked differences of approach between countries, the economic policy emphasis across much of the world was on more or less detailed government intervention. This extended in the extreme case to comprehensive central planning. But even in many countries which we would have thought of as "market economies", it included aggregate demand-management, macro-economic, policies targeted directly at growth and high levels of employment, and supported by direct macro-economic controls of various kinds, on the one hand; and it included extensive government regulation of, or direct involvement in, particular sectors of the economy, on the other.

Today, by contrast, there is a broad international consensus on the approach to economic policy - not just in the industrialised countries, but in many of the developing, emerging and transitional economies too, and endorsed by international institutions such as the IMF and OECD - which puts much less emphasis on government intervention and what it can be expected to achieve. Stability and sustainability are seen as the essential objectives for macro-economic policy; and more weight is put on structural, supply-side, actions, such as deregulation and competition, both nationally and internationally, as means of increasing the underlying rate of growth by broadening the scope for the productive energies of the private sector. In many respects today's consensus is in fact a reversion to an earlier orthodoxy.

In my lecture I should like to explore with you some of the key elements of tnis economic policy orthodoxy, as it applies today. I will speak from the perspective of a monetary policy practitioner in the United Kingdom, although not specifically or exclusively about our own national experience.

Macro-economic policy

Let me begin then with some thoughts about macro-economic policy taken as a whole.

Some thirty-odd years ago, macro-economic management was widely seen as something of a balancing act. No real distinction was drawn between its monetary and fiscal dimensions; they were used in combination with each other - and supported by various forms of direct macro-economic controls - to try to reconcile what were seen as the conflicting objectives of growth and full employment, on the one hand, and a reasonable balance of payments equilibrium and a pegged exchange rate, as well as a tolerable rate of inflation, on the other. Policy was essentially a matter of trading growth and stability off against each other. This involved expanding demand to increase activity and employment, when the stability constraints allowed, but then reining back - often quite abruptly - when the economy began to approach supply-side limits and evidence of imbalances emerged.

In practice this approach often resulted in substantial economic instability. Put perhaps rather starkly, the go-stop policy cycle produced a boom-bust economic cycle, often marked by financial crisis, and this volatility in turn engendered increasingly distorted, short-term, attitudes to savings and investment, and declining long-term economic performance. Even worse, the process was an explosive one as employers, employees and consumers learned to take advantage of the booms while they lasted, driving inflation progressively higher from cyclical peak to cyclical peak and unemployment progressively higher from trough to trough in response to policy restraint.

Given this experience academic, official, and broader public, opinion gradually changed, so that the more general perception now is that there is in fact no trade-off between growth and stability in anything other than the short term. Growth and stability on this view are not conflicting objectives. On the contrary, a stable macro-economic environment - in which economic decisions can be taken with reasonable confidence that they will not be

undermined by violent changes in policy, in response to large economic imbalances - is seen as a necessary condition for growth to be sustained into the medium and longer term.

This represents a major change - perhaps the major change - in approach to macro-economic policy. Even so it would be wrong to exaggerate the nature of the change. It does not, of course, alter the fact that growth and employment and rising living standards remain the ultimate objectives of macro-economic policy. Nor does it mean that there is no longer a role for discretionary management of aggregate demand. What it does mean is recognition that there are limits to what can reasonably be expected of demand management - recognition first, that demand management alone cannot determine the rate of growth of the economy, or therefore the level of employment, that can be sustained, which depends much more fundamentally on structural, supply-side, characteristics of the economy; and recognition, secondly, that demand management, in relation to that underlying, potential, growth rate, needs to look beyond just the short-term if erratic policy changes and damaging economic volatility are to be avoided. The essential aim of macro-economic management now is to moderate the economic cycle around the sustainable underlying growth rate, where too often in the past the effect had been to aggravate cyclical fluctuations.

(i) Monetary policy

Within the overall framework of macro-economic policy, monetary policy has increasingly come to be assigned the specific role of achieving and maintaining domestic price stability. This is on the basis that, in the longer-term, inflation is essentially a monetary phenomenon, which cannot persist unless it is accommodated by monetary expansion beyond that which is necessary to support sustainable real growth. The underlying thought - as in relation to macro-economic policy more broadly - is that, while you cannot increase the sustainable, potential, rate of growth of the economy directly, simply by providing additional monetary stimulus, you can provide for more efficient economic decision-making - in relation to saving or investment, or to resource allocation - by eliminating unpredictable fluctuations in the rate of inflation, which are

themselves a reflection of imbalance between monetary demand and the supply capacity of the economy. Ensuring stability in this broad sense is, on this view, the essential contribution that monetary policy can make to promoting economic efficiency - and so to increasing the potential growth rate indirectly.

This, too, is a huge change in policy approach. It is true that most central banks at least would traditionally have regarded controlling inflation as a core responsibility. In some cases - most famously in the case of the Bundesbank - the duty of preserving the value of the currency has long been written into the central bank's statutes. But what is remarkable today is the extent of the international consensus on effective price stability - in the sense of eliminating inflation as a factor in economic decisions - as the immediate aim of monetary policy; and this is increasingly reflected in more or less explicit targets for low rates of inflation against which monetary policy performance can be measured.

I do not suggest that the present consensus extends to every detail of monetary policy. Of course differences of opinion remain, both within and between countries, on particular aspects of monetary policy. There is an on-going debate, for example, about just how rigorously "price stability" should be defined and about the relative costs and benefits of seeking to eliminate inflation altogether rather than settling for just a relatively "low" rate of, say, up to about 4%. There is debate, too, about the most appropriate form of monetary arrangements - about operational independence of central banks, about transparency and accountability within the policy process, and about the respective merits of explicit inflation targets compared with intermediate monetary or exchange rate targets. And there is continual debate finally about the operation of policy - about the sensible pace of adjustment to "price stability" and about the importance of credibility of policy and the degree of flexibility it confers on policy makers. All of these questions can have an important bearing on the extent to which monetary policy succeeds, and we could easily spend the rest of the afternoon discussing them. But the key point for my present purpose is the extent of agreement on

the broad objective of "price stability" itself. Beside that all of these other issues are of lesser importance.

(ii) **Fiscal policy**

If price stability is the orthodox objective of monetary policy, there is a similarly broad consensus on the aims of fiscal policy - perhaps best described as fiscal "prudence" or "sustainability". In this case too there is still a good deal of debate about precisely what that means in a quantitative sense. A number of definitions are often discussed. These typically include the objective of a "balanced budget" over the economic cycle, with limits to the acceptable range of cyclical variation. They include the "golden rule", according to which only expenditures broadly to be regarded as productive public sector capital expenditures, should be allowed to be financed over the cycle by borrowing. And they include, at the very least, stabilisation of the ratio of public debt to gross domestic product, because of the implications of a progressively rising ratio for future debt servicing costs.

I am not aware of any strong body of analysis that points decisively to one of these measures rather than another as a practical guide to overall fiscal policy. A key consideration is that the fiscal position should be sustainable into the medium and longer-term, without the prospective need for continuously rising tax rates that would overburden private sector activity. But it is also important that fiscal policy should not place an excessive load on monetary policy to maintain macro-economic stability, because that too could lead to distortions to the pattern of economic activity that became unsustainable. In any event it cannot be assumed that inflation will in future erode the real burden of fiscal imprudence as it has in the past, not least because today's more sophisticated markets are liable to impose interest rate penalties more aggressively if they sense a risk of either monetary or fiscal indiscipline.

Again, there are substantial differences between countries on both their precise practice and their performance in relation to fiscal policy. But the crucial point is the extent of agreement on the

objective of "fiscal prudence", which typically - and especially at present within Europe - means substantial further fiscal consolidation.

(iii) Direct macro-economic controls

Finally in relation to macro-economic policy let me say a word about the change in attitude to the various kinds of direct macro-economic controls - ranging from rationing and the physical allocation of strategic materials in the immediate post-war period, to controls over prices and incomes, or foreign exchange or capital market or credit controls of various kinds - which were only finally discontinued in the UK some 15 years ago.

The motivation for eliminating them was partly a matter of economic efficiency. It became increasingly clear that as the economy developed and became more sophisticated, so the scope for arbitrary resource misallocation between alternative uses through an administrative rather than a market process also increased. But it was importantly also a result of diminishing effectiveness and the increasing practical difficulty of implementation.

If you will allow me a personal reminiscence, one of my early operational tasks at the Bank of England was to administer the queue of new equity issues. In principle I supposed that I was intended to regulate the supply of new equity issues to the capacity of the market to absorb them. I confess to you that this gave me some small sense of self-importance - until I rather quickly realised that I hadn't the foggiest idea of how to assess the absorptive capacity of the market and noticed that the market was quite capable of adjusting to new supply by varying the price! My job was abolished quite soon afterwards!

But in many instances the application of controls had more serious effects. The controls themselves provided incentives for the market to find ways around them, rendering the controls ineffective unless they were shored up by further controls ad-infinitum. The classic case was direct credit control. This first gave rise to the emergence of less soundly based deposit-taking institutions

outside the controlled banking system - a number of which subsequently collapsed in the UK's fringe banking crisis of the early 1970s. It later provoked disintermediation outside the banking system altogether - through the commercial bill market, which we felt unable to bring within the control for fear of simply driving the lending into channels that we would have been unable even to monitor. To attempt to impose administrative controls of this sort in our infinitely more sophisticated and truly global financial markets today would quite simply be a pointless nightmare! Happily we are not required to do so, and along with most other industrial countries today we rely almost entirely on market processes.

Now, to summarise up to this point, today's orthodox economic policy prescription is for macro-economic stability, involving monetary policy directed to effective price stability, within a framework of overall fiscal discipline, and operating through market processes. It is largely reflected in the terms of the "Madrid Declaration", adopted by the Interim Committee of the Board of Governors of the IMF two years ago, which calls for

- a strengthening of fiscal consolidation efforts to reduce significantly fiscal deficits beyond the effects of cyclical recovery and to cut debt-to-gdp ratios thereby facilitating lower real interest rates; and

- readiness to adjust monetary conditions to maintain price stability, as a condition for sustaining medium-term growth, including timely increases in interest rates with a view to preventing the emergence of inflationary pressures.

The same basic philosophy underlies the famous "convergence criteria" written in to the Maastricht Treaty in 1991 as pre-conditions for membership of the proposed European Monetary Union.

How then should we assess the effects?

Well, in one respect there has been very considerable progress. Inflation in many countries - including most of the industrial world - is lower than it has been for a generation. In the case of some developing countries, and some of the countries in transition where inflation had previously risen to the highest levels, it has fallen quite dramatically. But in other respects the results have recently been more variable. In some industrial countries, notably the United States, but also happily in the UK, low inflation over the past few years has been combined with relatively steady expansion and falling unemployment - though even there, there are concerns about increasing wage differentials between the skilled and unskilled. Elsewhere, notably in some countries in continental Europe, activity has recently been disappointingly weak and unemployment has risen, despite effective price stability.

Some commentators are inclined to put this uneven performance down to continuing deficiencies of macro-economic policies, with too much emphasis on stability - in some cases at least - and not enough on the truly good things in life, growth, employment and rising living standards. Now, no-one can pretend that macro-economic management is a precise science. Striking the right balance is not easy, and there will no doubt always be those who urge taking more risks with stability in the interest of higher output in the short-term. It is certainly true that you can have too much of a good thing and that macro-economic caution can be overdone.

But even if one were to allow, for the sake of the argument, that there may be something in this criticism - that monetary policy in some cases may have been over-rigorous and that the pace of fiscal consolidation - driven, for example, by the Maastricht convergence criteria within Europe - may be having a depressing effect on activity in the short-term, which is not yet being offset by increased confidence and activity in the private sector, that certainly cannot explain the upward drift of unemployment in many industrial countries stretching back over the past 10-15 years. The conventional explanation for this longer term trend is increasing structural rigidities in product and labour markets, which reduce the underlying sustainable, rate of growth, or

increase the "natural" rate of unemployment, and which cannot be directly addressed simply by macro-economic means. I should like, therefore, to devote the rest of my lecture to approaches to structural, supply-side, aspects of the economy that bear on the sustainable rate of growth and level of activity.

Structural policies

The context everywhere is accelerating economic change, driven by increasingly intense, and increasingly global, competition, itself fed by extraordinarily rapid technological innovation. Under the impact of new products which are cheaper or better adapted to meet customer demands, often embodying new concepts, new materials or new production or distribution techniques, and very often involving new skills on the part of both management and the workforce, whole industries, as well as individual firms within industries, appear to rise and fall with remarkable speed.

Now, of course, it is true that not everyone immediately benefits in this environment of intense competition and rapid change. Any new source of competition represents a threat to established producers. Countries may be faced with rising unemployment, businesses may become unviable, and individuals may be made redundant. So it is not surprising that many people see competition - whether domestic or international - as a zero-sum game in which if some people win then others must necessarily lose. And it is not surprising that established producers should over the years, have been tempted to try to hold on to what they have by seeking protection, whether through more or less overt restraints on international trade and investment, or, at the business level, through pressure for administrative barriers against entry or through exclusive tax breaks or subsidies for particular activities, or, at the individual level, through restrictive labour market practices or legislation to protect those in work. There have been endless examples of protective behaviour of this sort - both between countries and within countries - over the years, many of which survive.

Here too - or so it seems to me - perceptions have changed, with a growing understanding that competition increases aggregate activity, so that in reality it is a positive-sum game from which, collectively, we all stand to gain in the longer-term. The whole point about open markets and free and fair competition is that they act as a stimulus to economic growth and employment by allocating resources based on comparative advantage, directing savings to where they can be most productively invested and production to where it can be most effectively carried on to meet consumers' needs. This, incidentally, is why I regard the recent rapid economic expansion of the emerging countries and their increasing integration into the world's trade and payments system - especially countries like India and China with their huge populations - as the best possible news, not just for the peoples of those countries but for the world economy as a whole. But what goes for the benefits of international trade and competition, goes in exactly the same way for regional trade and competition and for trade and competition in one's own domestic market.

So, while the temptation to resort to protection inevitably persists not far below the surface, it has by and large been overcome - when push comes to shove - and there is a growing recognition, certainly within Europe, of the costs - in terms of structural rigidities - of unnecessary intervention. Today's orthodoxy in this area tends to emphasise the crucial role of open markets and the importance of flexibility and adaptability to take advantage of change, rather than action to resist it.

The effect, at the national level, in the UK has been remarkable. It was epitomised for me a year or so ago when I visited the North East of England and discovered an extraordinary sense of optimism among the business leaders I spoke to, where, less than a decade before, there had been only a sense of irreversible decline. I asked what had produced such a pronounced change in attitude, and one industrialist replied after a moment "Well I suppose that ten years ago we were looking inwards, and backwards to the past, seeking to defend what we'd had, whereas now, we are looking outwards and forwards to the new opportunities of the future". His remarks clearly reflected the mood of the other industrialists in

the room. One striking consequence has been increased emphasis on specialisation on activities in which individual businesses or employees have a comparative advantage, reflected at the business level, for example in rationalisation and demerging in management buy-outs, outsourcing of material inputs or the contracting out of specialist services and so on, all in sharp contrast to the tendency to conglomeration a decade or more ago.

What then, against this background, are the implications for structural policy?

I have already implicitly touched upon some of them. They key words it seems to me are flexibility and adaptability, and the key contribution that public policy can make to improving the sustainable, potential, rate of growth is to promote flexibility and adaptability across the economy as a whole.

More specifically I suggested a moment ago that this would involve avoiding "unnecessary" intervention. That, of course, very carefully begged the question of what "unnecessary" intervention means! It is frankly a question that, as a central banker, I am not at all qualified to answer.

Some forms of government intervention clearly <u>are</u> necessary if only in order to ensure effective competition. Legislation against monopolies or various forms of restrictive practices would fall into that category for example. But many other forms of intervention, just as clearly, have a more specifically social purpose. This would typically be true, for example, of many forms of regulation of the labour market, or of measures to provide for health and safety at work or for environmental or consumer or investor protection and so on. The only point I would make in relation to measures of this sort is that, however socially desirable they are in themselves, and while they can often improve market efficiency, they can equally involve burdens on business and restraints on competition, and that in turn can adversely affect the sustainable, potential, rate of growth and level of employment, both directly and by encouraging investment to go elsewhere. Weighing the social benefits of intervention or regulation against

the possible economic costs is, of course, the very stuff of political judgment. As a central banker my role is the much simpler one of pointing out that there can be costs as well as benefits.

Somewhat similar considerations apply to decisions relating to public sector provision. No matter what form this takes - defence or transport, health or education, income support or provision for old age and so on - it has to be paid for, within the limits to public sector borrowing which I discussed earlier in the context of macro-economic fiscal policy, through taxation. And, again, the burden of taxation can adversely affect growth and employment. Here, too, of course, just where the balance should be struck is intrinsically a matter of political judgement, which needs nonetheless to take account of both sides of the ledger.

As you would expect, political priorities in all these areas differ from both country to country and time to time. There nonetheless appear to be a number of common themes. Non-discrimination - on grounds of nationality of ownership or origin, but also on grounds of race or sex or physical disability - for example, is increasingly justified in terms of its economic benefits, by improving the productive capacity and flexibility of the economy, as well as in social terms. Raising the quality and adaptability of the labour force more generally, through lifetime education and training is similarly seen as a means of raising the sustainable growth rate - something which is well understood in the emerging nations of Asia and of which, I am sure, Governor Deshmukh would have strongly approved. Increasingly, too, the public sector is reducing its direct involvement in industrial and commercial activity - through privatisation, and, in our own case, the private finance initiative in relation to new infrastructure provision - in order to take advantage of a "cheaper lunch" where private sector incentives and disciplines can improve the economic efficiency with which particular goods and services can be provided. Another frequent theme is encouragement of small and medium-sized businesses, which can often respond more flexibly to changes in demand and, which typically employ proportionately more people than larger companies.

But, despite such common themes, it would be misleading to suggest that there is a standard blueprint or orthodox prescription in relation to structural policies, which is anything like as clearly defined as the more technical, macro-economic, orthodoxy that I discussed in the earlier part of my lecture. The Madrid Declaration nevertheless touches on some of the relevant issues in endorsing, as a third element in the common strategy agreed by the Interim Committee:

- structural reforms to eliminate impediments to sustained growth, including steps to dismantle non-tariff trade barriers and to ensure the long-term financial viability of health care and public pension systems. The Committee notes that problems of long-term unemployment and lack of jobs for young and unskilled persons should be addressed by efforts to improve education and training and by fundamental labour market reforms to reduce disincentives to employment.

These issues are receiving increasing attention in Europe.

Conclusions

Mr Chairman, in my lecture today I have - unusually - strayed well beyond my usual macro-economic, or more specifically monetary policy, beat. I have done so because I recognise that macro-economic policy - and within that monetary policy - does not operate in a vacuum.

I very much share the orthodox view that macro-economic policy should be directed to stability - and that the particular role of monetary policy is to provide permanent price stability - as a measure of underlying balance between aggregate demand and the supply capacity of the economy and as a necessary condition for effective, long-term, economic decision-making. That is the greatest contribution that macro-economic policy can make - indirectly - to increasing the sustainable rate of growth of activity, to increasing unemployment and to rising living standards.

But I recognise that stability, although a necessary condition, is not in itself sufficient to satisfy wider political and social aspirations - even entirely reasonable aspirations. The orthodox answer then is structural reform to increase economic flexibility and adaptability in a changing world environment. But it is not easy to apply.

The unemployed or those living in poverty are unlikely to care very much whether their condition is a result of macro-economic or structural weakness. They simply want relief. I am concerned that if, for whatever reason, stability becomes associated in the public mind with weak growth and high unemployment, then there is likely to be a natural temptation to set the present orthodoxy on one side. The temptation then would be to resort again to forced-draught expansion, notwithstanding the repeated evidence from the past that this is likely only to result in renewed instability and, in the longer-term, simply to make matters worse. Or the temptation would be to resort to protection which may bring short-term relief to the particular country or business or group of employees, but to our collective disadvantage over the longer-term.

The essential point is that the key elements of today's economic policy consensus - monetary stability, fiscal sustainability, and structural flexibility - must all hang together. If they do not, then, in the famous words of Benjamin Franklin at the signing of the US Declaration of Independence in 1776, we will all most assuredly hang separately.