

Lecture One
Economic Liberalism,
Central Banking
and the Developing World
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Economic Liberalism, Central Banking and the Developing World

It was a great honour to be invited to deliver this inaugural lecture in memory of L.K. Jha. And it is an enormous pleasure to find myself back in India again, albeit only briefly, after an absence of many years.

Anyone looking at India today can hardly fail to be impressed by the country's recent economic development, despite the internal pressures of population growth and external shocks like the present crisis in the Gulf, which I know will be hitting India particularly hard. It is a considerable achievement that you can say that you are self-sufficient in foodgrains and that the drought of three years ago—followed, I am relieved to note, by three excellent monsoons—caused nothing like the major economic and social disruption of earlier, and lesser, droughts. It is notable, too, that the trend rate of growth has risen from around 3½ percent during the three decades following Independence to 5½ percent over the past ten years. One can also only be impressed by the strong industrial development that India has achieved in a range of sectors.

These developments in India have taken place against a background of a remarkable period of growth in world trade and wealth. We have seen eight years of sustained expansion, which is a record. This has not, however, been shared by all. In some parts of the world, poverty has increased and growth has been modest, or negative. And for much of the developing world, external debt has remained a major problem. But while many countries with debt problems continue to face huge and seemingly intractable difficulties, there have also been encouraging instances of progress with debt reduction and structural reform.

Quite apart from steady growth, the years in which you and I have been central bank governors, Mr Governor, have seen some fairly profound changes in the world economy. There has been increasing liberalisation of market structures; partly because of this, world markets have become more integrated, so that we have come to talk of the “global marketplace”, and there has developed a broad international agreement that the defeat of inflation has to be the number one priority of economic policy.

In parallel with these developments – and in many ways underpinning them – has been a growing conviction that scarce resources are most efficiently and effectively allocated by market forces; and that economic welfare is therefore greater in a market economy. In other words there has been a shift of consensus towards economic liberalism.

And I therefore thought I would make this the theme of my remarks today, Mr Governor. I shall suggest why it has become the dominant economic outlook; how it is reflected in current developments in the European Community; and the effects it has had in the United Kingdom through our programme of financial sector reforms. I shall then go on to say something about its relevance, first to central bankers, and secondly to developing countries in general and India in particular.

The General Argument for Economic Liberalism

As I said, it is interesting to start by asking oneself why this shift to economic liberalism should have occurred. After all, the arguments between *dirigisme* and *laissez-faire* have been in progress for at least two centuries, and I do not think that there has been any decisive breakthrough at the purely intellectual level. Perhaps what has been most important is the trend of events in the world at large. First and foremost, it has become increasingly obvious that central planning has produced results which, on a wide range of criteria,

are less impressive than those of more liberally managed economies, and by a rapidly growing margin. Secondly, many restrictions on economic behaviour, particularly in Europe, were in response to the extreme demands imposed on nation states by the two World Wars. In the long period of general peace since 1945, public tolerance for those restrictions – and indeed for any restrictions which do not have some clear justification – has greatly diminished. Moreover, there has been no overriding practical obstacle to the removal of restrictions. In the absence of a major war or a dramatic economic collapse, such as the inter-war depression, I think that there is unlikely to be any revival in enthusiasm for central direction of the economy.

This does not mean that government has no role in a market economy. Measures are necessary to prevent monopolies and restrictive practices which would distort the market process. Even more fundamentally than that, a stable basis of contract and property law is essential, as well as machinery to enforce it; these are very pressing issues in the emerging market economies of Eastern Europe. Nor am I intending to deny the possibility of market imperfections or of so-called externalities; for example, it has been wholly accepted, even in liberal economies, that measures are necessary to combat pollution and generally protect the environment and that a degree of regulation of some areas of the economy can be appropriate, or even necessary.

Financial services – and particularly banking – merit *special attention* in this respect; because of their fiduciary element, because the service itself is mostly “invisible” and thus often difficult for the man in the street to comprehend fully, and most importantly because of the dangers of knock-on effects and systemic problems in the event of a major failure. Quite sophisticated regulation is therefore required, both in the interests of depositors and investors, and to guard against systemic collapse.

But in my strongly held view, this is entirely compatible with the basic principle that our economies should be founded on the market.

I should perhaps say that, for many, the commitment to economic liberalism is as much a matter of political economy – or even straight politics – as of pure economic doctrine. Above all, it is associated with the belief that individual liberty is the basis of a decent society or is, as some would put it, a fundamental human right. This connection between economics, practical politics and political philosophy is nowhere more obvious than in Eastern Europe, where the dismantling of the “command economy” is an integral part of the democratisation and liberalisation of their countries.

But while the move away from central planning or control – a process, by the way, that will not be easy or painless – is most dramatic in Central and Eastern Europe, greater emphasis on more competitive, market-oriented systems is by no means restricted to the former Communist bloc. In numerous other countries the focus of policy has in recent memory shifted in the same direction, admittedly to varying degrees and from vastly different starting points.

These developments are, moreover, by no means limited to domestic deregulation within national economies. We are also witnessing a process of *international* liberalisation, in the sense of opening up domestic markets to firms – and therefore competition – from other countries. One very obvious example of this is the way the European Community's Single Market programme is being implemented. The Community is also looking for ways of expanding the benefits of the Single Market to EFTA countries and to the emerging market economies in Eastern Europe.

Liberalisation in Europe and Moves to Economic Union

We are, of course, at an extraordinary point in European history, even setting aside the dramatic events in Eastern Europe. The Community is in the middle of establishing itself as a single, free market in goods, services, capital and labour, with the minimum of impediments to trade, and maximum openness. In other words, we are aiming finally to create the Common Market that was so widely talked about by the Community's founding fathers in the 1950s and 60s.

This Single Market programme – popularly known as “1992” – is, I should stress, still unfinished business.

But its broad shape is by now reasonably clear. Of the 300 or so directives required to give it legal force under Community law, nearly 200 have already been agreed. Implementation in individual countries is not progressing quite so fast, not least because this often requires consequential national legislation, but I am glad to say that the United Kingdom has an excellent implementation record.

The opening up of the financial services market in the Community is absolutely fundamental to this programme, since it is the means by which savings, wherever in the Community they arise, are channelled to productive uses in the Community (or beyond). Some observers initially feared that the Single Market might, notwithstanding its objectives, actually end up frustrating competition in the financial services industry, because of extra layers of regulation; and that, to make matters worse, it might also prove to be protectionist in relation to non-member countries, because of undue restrictions on the entry of foreign financial intermediaries to European markets. In the event, I am glad to say that those fears have not been borne out. The European Single Market in financial services will be based on competition and free access. It is no easy matter to give full practical effect to these principles, and we will surely find that not everyone is entirely satisfied with the results. But there should be no doubt as to the intention and objective.

The European Single Market is by no means an overnight creation, or even just the outcome of the 1992 programme. It will rather represent the culmination of efforts stretching back some 30 years; years which saw a number of false-starts. For a European coming to India, it is therefore particularly striking to think that a territory much larger than the European Community and with more than double the population has long been a single market. And, what is more, you are a single currency area, which as you will know is for some the goal that Europe should set itself. Indeed, in some minds, the 1992 project is only one part of, or one step on the way to Economic and Monetary Union, and beyond that even Political Union.

My own view is slightly different. I believe that greater monetary integration in the Community should be evolutionary and, in particular, should not run ahead of greater economic integration. The Single Market combined with greater policy co-ordination within the framework of the European Exchange Rate Mechanism-which, as you will know, the UK has very recently joined-will do much to foster this needed economic convergence. But the forces unleashed by 1992, while considerable, will take time to show their full effects. Moreover, there needs to be much greater progress towards widespread price stability in the Community before moves towards a single currency and single monetary policy could make practical sense. This is not to say that concrete steps towards closer monetary integration could not – or should not – be taken.

The UK Experience of Financial Liberalisation

It will therefore in my view – and indeed should – take us Europeans some time to catch up with India so far as monetary integration over a large territory is concerned. But while India is a single market and a single currency area, I think you would agree that it is not an open or deregulated economy. I hope you might therefore find it interesting for me to say something briefly about the UK's experience of deregulating and liberalising its financial sector.

Perhaps I should start by saying that London's history as an open and international financial centre goes back centuries. Indeed, the key factor in London's position in world banking is that we have always – and I mean always since the Italians brought banking to Lombard Street – welcomed foreign banks on substantially equal terms to indigenous banks. It is no accident that foreign firms collectively dwarf British firms in many parts of the international financial services industry in London. And that, I should add, gives me no concern at all.

By comparison, wholesale liberalisation of our financial markets is a relatively recent phenomenon, though by no means so recent as commonly thought. One of the most important early steps was taken nearly twenty years ago, when in 1971, the cartel of the major London clearing banks was finally brought to an end.

The key moment was in 1979, however, with the total abolition of exchange controls. This opened up the British economy in a way not experienced since before the Second World War: it was, by common consent, the single most important development in financial markets for a generation. Thereafter a plethora of rules, formal and informal, relating to the growth of direction of banks' lending was allowed to lapse.

This bonfire of controls was followed by a bonfire of restrictive practices in the securities markets. In 1986 the rules and practices of the Stock Exchange were completely overhauled, in what has become known as "Big Bang". Our stock market was opened up so that the traditional dealers faced competition from banks and foreign firms, the dealing system was reformed and the system of fixed commissions abolished. Parallel changes were made to the market in government stocks. UK capital markets underwent radical change.

This process of liberalisation, in the sense of breaking down barriers and opening up markets to competition, has by no means entailed a slackening of prudential standards. But the connections between liberalisation and our regulatory reforms have been complex. For example, a peculiar feature of our pre-1979 exchange controls was that they did not prevent London from serving as a haven for foreign business driven out of its natural market by foreign controls. Thus although British residents could own Eurobonds only subject to the provisions of our exchange controls, the Euro markets developed and prospered in London. More recently, we found that, exchange controls having been abolished, any regulation of the financial sector had, as one might say, to cover the waterfront. The regime established under the Financial Services Act of 1986, which set up the Securities and Investments Board and the Self Regulatory Organisations, is therefore fairly comprehensive in its scope.

What have been the consequences of these reforms? Most obviously and importantly, the efficiency of financial intermediation in the domestic economy has been enhanced. The main beneficiaries are users (or customers) of financial services, who have much greater choice and, on the whole, lower costs, although the effects may be uneven.

But what of the institutions and intermediaries? They have to strike a balance between risks and returns. A liberal system, such as that introduced by Big Bang in 1986, certainly gives room for mistakes, and some firms have made them. Some securities market institutions launched themselves over enthusiastically into the new era, with ill-judged sorties into unfamiliar areas. For a period London became saddled with evident over-capacity in the securities industry. Inevitably there has been retrenchment – and also casualties – but I should note that we as a central bank made no attempt to prevent this over-capacity, other than bringing the facts to the attention of potential new-entrants, on the grounds that only competition could sensibly determine who should succeed, and who fail. As a result, I believe that our securities markets are more competitive.

I would not – could not – pretend, however, that an open financial system – domestic and international – is a bed of roses. I reject the argument that liberalisation leads to market instability and I hold that sound prudential supervision is consistent with liberalised markets. But I must, I think, concede that liberalisation can complicate the operation of monetary policy.

In the UK, following deregulation, the monetary indicators have become more difficult to interpret and, for some years, the relationship between broad money and national income – and thus inflation – has been unclear. Faced with this, we abandoned broad money targets as a key benchmark for policy-making in the mid-1980s, and instead we take account of all the available information concerning monetary conditions and the real economy. (I should stress, however, that there was *never* an automatic read-off of policy from the money statistics; it has *always* been a judgemental process.)

The problems created for policy by deregulation have therefore been quite material in recent years. Liberalisation caused considerable shifts in individuals' and companies' liability and asset portfolios as they took advantage of their new opportunities. It may be that this will prove to have been a temporary phenomenon, but it is as yet too soon to tell.

One further element of the liberalization process will be important to the future conduct of policy. Financial liberalization has appeared to alter the way that the effects of monetary policy – and particularly short-term interest rates – are transmitted to the economy in the United Kingdom. The recent tightening of monetary policy there, with a doubling of nominal interest rates in 1988, had its greatest impact on the housing market, house building and construction more generally. In the immediate post-war years none of these channels would have been effective. Home owners were mostly very liquid, house building was nearly all in the public sector, credit was rationed, building required a licence, and materials were subject to official allocation. No wonder that in those days higher interest rates were seen merely as raising the cost of government borrowing! With progressive liberalization in the UK this situation has changed. Not only is credit now allocated by price, but because of increases in corporate and personal net debt levels in response to the changed opportunities brought about by liberalization, our economy has become more sensitive to interest rates.

This is, on balance, desirable. In the world I have been describing, the instruments of policy through which the authorities can influence macroeconomic conditions (and, most especially, the rate of inflation) are relatively few. The more sensitive the economy to the available policy instruments, the better.

My general belief in free markets has not therefore been dented by the UK's experience. I regard the benefits we have derived from our own general liberal strategy as being very considerable.

The Place of Central Banking in a Market Economy

My description of the UK reforms has taken me to the operation of monetary policy. And perhaps this is therefore the point to ask how we as central bankers, Mr. Governor, are affected by the developments I have been describing. Why are we increasingly regarded as an essential element in a successful market system? Paul Volcker has interestingly, but provocatively, asked why so much emphasis is being given to the early establishment of central banks in the emerging market-oriented economies. And he has pointed out that, historically, central banks – and central banking functions – emerged, or evolved, only following the development of financial markets. Bluntly, then, what is our role? What part can we play in a deregulated, liberalised world economy?

In my general account of economic liberalism, I stressed that the role of government – or, more broadly and accurately, of the State – is by no means negligible in a market economy. I deliberately avoided any mention of central banks at the point, but in fact we do have an essential role to play. I see our role as basically threefold.

First, a market economy requires a stable macro-economic environment and, above all, price stability. Since the purpose of freeing markets is to produce a structure of *relative* prices which reflects relative scarcities, the *general* price level must be as stable as possible; this will make relative price movements much clearer. And monetary policy – the core of central banking – is the central plank of any counter-inflationary strategy. Central banks must therefore pursue the goal of price stability, through their own operations and, where appropriate, through their advice to Governments.

Secondly, a liberal economy must obviously avoid major, systemic financial crises. Central banks must therefore seek to ensure the integrity and stability of the financial system. This means ensuring that payment and settlement systems and other parts of the market infrastructure are sound, with risk exposures transparent and recognised. And it also requires that proper prudential standards for individual intermediaries are set and adhered to. This is strictly in the context of financial stability. The need for prudential regulation should certainly not be an excuse for propping up every individual institution.

Thirdly, a free market requires an absolute minimum of obstructions and impediments to efficient and effective competitions. Central banks should accordingly be on the lookout for such impediments in financial markets, and should work with other competent authorities to have them removed where they are found. I earlier mentioned some of the measures taken in London to this end.

If these three broad functions are, as I hope, uncontroversial enough, it is nevertheless extremely important to be clear about what central banks cannot deliver. Specifically, they cannot deliver high level of economic growth or full employment in the short run; and indeed these other objectives of economic policy are likely to be seriously jeopardised if the object of monetary policy deviates from the achievement of price stability, which is an absolute pre-condition of sustainable growth over the long-term. The best contribution that the monetary authorities can make to long-term growth is therefore to pursue a resolutely counter-inflationary strategy.

The record of countries in both the developed and developing world shows that success in the battle against inflation depends, in no small degree, on the credibility of the authorities. Inflationary expectations are much lower in countries where there is a widespread and deep-seated belief that the authorities will not let up. This may make counter-inflationary policy less painful, but it does not make the job of the authorities any easier. Credibility is easily lost, and is very hard to regain. Constant vigilance is needed.

It is therefore *vital* that this quality of credibility is accompanied by legitimacy. Where inflation rears its head, the policy response of the authorities needs to be tough, swift and resolute. Since this may entail pain – in terms of loss of output or jobs in the short term – and since the authorities may sometimes act before the signals and costs of inflation are widely apparent, the authorities must enjoy the understanding, trust, and most of all confidence, of the general public.

These requirements of credibility and legitimacy plainly have implications for the institutional arrangements for the conduct of monetary policy.

In particular, a central bank can benefit from a clear mandate to pursue price stability and must equally be accountable for its record. These questions of independence and accountability are being keenly debated among EC member states in the context of possible monetary union, since a new institution – let us call it a European central bank, if you like – would be needed to manage an ultimate single currency, if one were ever introduced. I do not wish to take up your time today with a detailed excursion into the constitutional questions which surround this issue – and of course the status and role of the central bank varies from country to country for historical and other reasons – but let me simply say that while a statutory mandate is not essential, certainly not logically essential, to price stability, it has obviously been used to great effect in Germany, Europe's biggest post-War economic success story.

As to accountability, a central bank needs a properly constituted legal structure, within which its powers can be determined. But accountability ought also to embrace the requirement to explain and defend its actions to public opinion, and its elected representatives. Perhaps the best developed illustration of this process comes from the United States, where the Chairman and other members of the Board and staff of the Federal Reserve System regularly appear before Congressional Committees.

Economic Liberalism and Developing Countries

I believe that these thoughts on central banking apply, Mr. Governor, to developed and developing countries alike. But I recognise of course that much of what I have been saying this evening may be construed in the light of my representing the central bank of an industrialised country, and be regarded as of less relevance to developing countries. I am very conscious that there is a lively debate as to what weight developing countries should give to financial liberalisation.

I would certainly want to suggest, however, that developing countries are little different from the developed economies insofar as they need an efficient financial system for allocating resources. Similarly, an open regime, which allows foreign firms to compete on equal terms with indigenous firms, can spur efficiency and bring much needed capital and expertise. These positive effects do perhaps, however, need to be set against some broad arguments that point away from *doctrinaire* economic liberalism, such as the relative size of the rural population and the extent of widespread poverty in parts of the developing world. So that, although market forces remain the best basis for resource allocation and improved living standards, they might be tempered by a recognition of the need to protect disadvantaged sectors of society.

I can also appreciate, in the context of advancing foreign competition, worries about profit remittances and concerns that indigenous firms should be permitted to develop before they are exposed to open competition. But it is worth bearing in mind the advantages of openness, such as that an efficient on-shore financial sector encourages people to transact their business on-shore, whether through domestically-owned or foreign-owned firms, and may even succeed in attracting other international business. So I do not think that countries which are relatively closed to foreign firms should be dissuaded from agreeing to a gradual opening-up of their markets. This might be undertaken in the context of the GATT Round and any follow-up negotiations, and perhaps I might therefore say a few words about them.

It is now four years since the Uruguay Round was launched at Punta del Este. The agenda was far more ambitious and complex than any of the seven previous rounds. It aimed to cover, for the first time, areas beyond mere trade in industrial goods. The inclusion of agriculture, for example, is a very ambitious project, and an area where the European Community has itself still to face up to some of the messages I have been offering here today. Another new area has been services, including financial services.

A reasonable goal for the financial services negotiations would, to my mind, be the achievement of access for the firms of signatory countries to the markets of others under conditions of national treatment, but even that now looks ambitious. I should add that I would not wish prudential standards to be relaxed by an eventual agreement, and it is therefore heartening that there is a widespread consensus that any deal should continue to allow individual countries to practise "reasonable" regulation, although there could well be practical difficulties in ascertaining which measures are reasonable, as opposed to discriminatory against foreign suppliers.

Progress seems to have been disappointingly slow, however. While I expect that a broad agreement on principles and frameworks may well be achieved, at least at the political level in time for the conclusion of the Round in December, it seems that to introduce effective liberalisation, more efforts may be needed well beyond then.

Returning to my main theme, my disposition, as you will have sensed, is towards developing countries increasing their reliance on market forces. What any particular country should do must, I would suggest, depend upon its particular circumstances. I do, for example, think there is a strong argument for the Eastern European countries moving to a market system just as quickly as practicable. The costs of a gradualist approach there, in terms of disruption and resource misallocation, are likely to be high. You will be better able to judge whether the same applies to all parts of the developing world.

India

In particular, how do my arguments translate to the financial system in India? I can hardly leave your country without attempting to address this question, albeit in an extremely tentative way and after stressing that I am not at all expert on Indian affairs.

Clearly a system which is conducive to the mobilisation and efficient allocation of savings is important to India, but it is probably also fair to say that financial liberalisation is not the first priority of everyone in India. I would also acknowledge that the particular social and economic circumstances of India may be felt to justify a certain amount of official encouragement of the way the financial sector develops.

It is noteworthy in this connection that India has achieved an impressive increase in rural savings in recent years. This could not have been achieved without a basic financial infrastructure, accessible to rural communities, and governments do have a role in encouraging and facilitating the establishment of such an infrastructure. Schemes to encourage savings in developing countries may be affected by such factors as literacy, mobility or a comprehensive tax system, and may therefore be faced by quite complex problems. However, I feel one should query whether the direction of credit to priority sectors adds up to a better overall allocation of economic resources than a more market – oriented system might deliver. The answer must to some extent depend on the weight attached to social as opposed to economic objectives. I am not qualified to judge that – but it is an important question which ought not to be dismissed.

Nevertheless, I would think that any moves to increase competition in the Indian economy should be generally welcomed, whether in the field of internal deregulation or increased international exposure. I would suggest that there should be a presumption in favour of the liberal approach, with any restrictions and regulations having to be specifically justified, regularly reviewed and reduced to the extent that economic circumstances permit.

Given the prevalence of public ownership here, I think it would be misleading for me not to add that, as a matter of general principle, I think a market economy needs to be based on clear property rights and benefits from a wide measure of private ownership. But what is even more important is competition. In the banking sector, this requires avoidance of the moral hazard to which bank managements can be prey if they are not accountable for the performance and profitability of their firms.

In many ways you have of course been moving in the direction I have urged. It is, I think, probably still fair to describe India's economic structure and policy as largely inward-looking, but a number of measures have been taken in recent years to deregulate your financial system somewhat – the growth in the stock market, the deregulation of some interest rates, and the introduction of new money market instruments are major examples of this – and to improve the transparency and liquidity of your capital markets. I suspect that the economic achievements I mentioned at the outset are to some extent associated with the liberalising policies adopted in the early 1980s and continued since.

And I have, of course, Mr. Governor, noted your own remarks earlier this year concerning the efforts “to impart greater flexibility, dynamism and competitiveness to the financial system through a process of liberalisation.”

I applaud the steps taken so far, but you will not be surprised to hear that I would encourage you to continue. I feel sure that this would be, over the longer term, the best means of achieving an efficient and healthy financial sector and would therefore benefit the whole economy.

Were L.K. Jha with us today I feel sure he would not have been a mere bystander to the developments and debates I have been describing, and I am hopefully confident that he would have been sympathetic to the emphasis I have placed on open markets and the price mechanism. As one who once acted as Chairman of the GATT, who was his country's representative at the IMF, and who served on the Brandt Commission on North-South questions, he would no doubt have been adding a voice of experience and pragmatism to today's debates. He would, I suspect, have been hoping that significantly freer trade, in both goods and services, would emerge from the present Uruguay Round of GATT negotiations; and, as an ex-Governor of the Reserve Bank, he would surely have been in broad sympathy with the steps towards greater market orientation of the world's economies and the increasing recognition of the paramount importance of defeating inflation, and the critical role central banks must play in that process.

But in all this, he would, no doubt, have been a persuasive advocate for developing countries in general and of India in particular. And it has therefore been a special privilege to be here today.