A CENTURY OF ECONOMIC CRISES

Nick Macpherson

Strand Group, Guildhall, 9 October 2019

I'd like to thank the City corporation for hosting this event.

I'd also like to pay tribute to two people who have helped informed this lecture. The first is Dick Roberts, one of the great economic historians of recent times and author of *Saving the City: the Great Financial Crisis of 1914,* who died all too young two years ago. The second is to that veteran economic commentator, William Keegan, who I hope is here tonight. William last year entered his 9th decade and I strongly commend his recent book *Nine Crises: 50 years of covering the British economy from devaluation to Brexit.*

Today, I would like to talk about what causes economic or financial crises.

I am going to do it largely by reference to the UK, partly because it has had more than its fair share of economic disasters, and mainly because I have plenty of personal experience of them.

But for those of you who think I am being a littler parochial, I believe what I have to say has wider application whether in relation to other industrialised economies or emerging markets. And even to corporations.

Crises can take many forms.

First, there is the **classic external shock.**

1914 is a case in point. Austria's delivery of its ultimatum to Serbia on Thursday 23 July (following the assassination of Franz Ferdinand) precipitated a global banking crisis of a sort not seen til 2008.

At first, the ultimatum was not taken too seriously. As Asquith said "with a laugh" to Lady Ottoline Morrell, when they went on a walk together on Saturday, 25 July, "this will take attention away from Ulster which is a good thing". But as Austria withdrew its ambassador from Belgrade that weekend, market participants began to panic.

London was most exposed. In those days, the value of the London Stock Exchange was greater than that of New York and Paris put together. The stockbrokers themselves came under pressure not least because of the closure of the Paris stock exchange on Monday, 27 July. Banks began to call in their loans to stockbrokers. The accepting houses which in those days dominated the commercial bill market in turn came under pressure as international investors sought to liquidate their holdings. The London Stock Exchange was finally forced to close on Friday, 31 July.

Banks themselves faced increasing demands for gold. They in turn began to ration the amount they were prepared to pay out to retail customers. And queues began to grow outside the Bank of England whose gold reserves fell by a third in three days.

I recently went and did my own research at C Hoare & Co a small but venerable bank I have the privilege of chairing.

Here, customers proved more reliable. According to the partners' memoranda book: "On Saturday Aug 1st Bank Rate was raised to 10% & the run continued, though as far as we were concerned only two of our customers made any unusual demand on us and we received many offers of help from our customers should we require it." But, then as now, Hoare's proved the exception to the rule.

The Bank of England responded raising interest rates from 3 per cent to 4 per cent and ultimately to 10 per cent. This was straight out of the 19th century central banking textbook.

But as John Maynard Keynes, who came down to London in the side car of his brother in law's motorcycle that Saturday to form part of Lloyd George's emergency Treasury team, observed: raising interest rates merely undermined confidence rather than restoring it.

Lloyd George took charge and, following a four-day bank holiday from 3 to 6 August during which Britain declared war on Germany, announced a month's moratorium on payments of bills of exchange and, more importantly, the printing of £1 bank notes by the Treasury. At the same time the newspapers, encouraged by the government, began a campaign against the "unpatriotic" hoarding of gold. Markets reopened on Friday 7 August. Interest rates were reduced to 5 per cent on 8 August, and although the Stock Exchange remained closed til January 1915 calm was restored.

1914 is interesting since it's an example of policymakers learning from history but adapting it to modern purposes. In 1797, Pitt had suspended gold convertibility and had authorised the Bank to issue lower denomination notes. In 1914, the Treasury followed that precedent – printing notes extraordinarily quickly – in a couple of days. (I sometimes wonder whether it could issue at the same speed today, though – thanks to De La Rue - there is a supply of Treasury Bills with my signature on it against the possibility of an electronic failure somewhere in a safe in the Debt Management Office).

But Keynes strongly advised against suspending gold payments in 1914 to maintain economic credibility and London's pre-eminence as a financial centre. And the Government took his advice. (Exactly the same debate took place in the USA which – as a capital importer – faced a dollar sell off in the early months of the war).

Unfortunately, governments can sometimes take the wrong lessons from history.

Cast your minds back a further 100 years to 1821. Britain returned to the gold standard after a long and expensive war at sterling's historic parity.

This caused considerable dislocation. And recession followed. But these were the years before organised labour. Workers lost their jobs, and the impact on living standards was exacerbated by the Corn Laws. But wages adjusted downwards, and the economy recovered.

Britain chose to pursue precisely the same policy after the first world war, with the then Chancellor, Winston Churchill, returning Britain to full gold convertibility[1] at the pre-war parity of £=$4.86 in 1925. But the world had changed.

Labour markets had become much more regulated and inflexible.

The Bank of England was no longer the dominant central bank effectively setting policy for the world.

Prices fell. But wages did not adjust. Unemployment rose. A year long miners' strike began in 1925, followed by a general strike in 1926.

When the Wall Street crash and subsequent world slump compounded already difficult conditions, the minority Labour government came under increasing pressure to cut wages. The Cabinet was divided. The government collapsed. And Britain left the gold standard in 1931 never to return.

It's worth recalling Keynes's comments on Churchill "*Why did he do such a silly thing? Partly, perhaps, because he had no instinctive judgment to prevent him from making mistakes; partly because, lacking this instinctive judgment, he was deafened by the clamorous voices of conventional finance; and, most of all, because he was gravely misled by his experts*."

Similarly, it can be argued that British policy makers' obsession with joining the ERM from the mid-1980s was a throwback to a world of fixed exchange rates providing certainty and an anchor.

I am afraid I was one of the guilty men who believed the ERM was the answer back then. All other attempts to find an anchor for monetary policy had failed.

Why not tie the £ to the strongest currency in our main trading block the Deutsche Mark?

There were three errors in this.

First, by the time we joined, Unification meant that Germany was in precisely the wrong point in the cycle compared to the UK. They were raising interest rates at a time when British domestic policy warranted a cut in rates.

Secondly, with typical British arrogance, we assumed that unlike France and Italy, we could simply lock into an exchange rate of £ = DM2.95 and keep the exchange rate there. The

[1] Technically, Britain had never left the gold standard. But various regulations, such as the banning of gold exports, introduced in WW1 meant that sterling was no longer convertible into gold.

fact is the French franc and Italian lira took years to find their equilibrium level against the DM after many painful mini-crises and realignments.

And finally and most importantly we failed to recognise how markets had evolved. The abolition of exchange controls, Big Bang and wider deregulation under President Reagan and Mrs Thatcher had increased exponentially the size of the foreign exchange market. Foreign exchange intervention, even when coordinated with others, was simply a drop in the ocean, as Britain was to find on Black Wednesday in September 1992.

No doubt some of you in this room made a fortune that day. The fact is the authorities had rigged the market in your favour.

The return to the Gold Standard in 1925 and entry to the ERM in 1989 are interesting examples of crises which were Government created. In each case the government did not have to enter the regime and in each case it had a choice of the rate of exchange.

It's a reminder that **for the most part crises are home made.**

Policymakers become mesmerised by a particular theory or policy, which may have been right once but no longer holds good. The old Keynes quote still holds good.

"Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back"

But occasionally policy makers can become committed to policies which the market simply will not tolerate, (Boris Johnson and Jeremy Corbyn please take note!)

The mid-1970s is an interesting case in point.

Britain chose to embark on one of its biggest monetary expansions in 1972, just when a world economic boom – driven amongst other things by the Vietnam war - was beginning to put pressure on commodity prices.

The British economy grew faster in 1973 than in any year before or since. Growth of over 6 per cent is almost unimaginable these days.

The Yom Kippur War that autumn resulted in a massive oil spike.

The miners went on strike and our then Prime Minister having implemented a three day week to conserve coal stocks chose to call a general election asking the question who governs Britain: the Government or the Miners?

As tends to be the case when the people are asked a silly question, they gave an answer the questioner didn't want.

And Labour unexpectedly formed a minority government.

With the objective of getting re-elected, they embarked on a series of risky policies.

They abolished prices and incomes controls and returned to free collective bargaining: not a bad idea in theory but a little foolish when Trades Union membership was at its peak.

They committed themselves to nationalising the aerospace and shipbuilding industries.

They raised taxes. This was the era when you could end up paying income tax at a rate of 98 pence in the £.

And above all they went on a massive spending splurge.

Things were bound to end badly. As early as December 1974, my predecessor but four as Permanent Secretary to H M Treasury, Sir Douglas Wass was advising the then Chancellor Denis Healey that inflationary pressures, and the balance of payment and budget deficits were all increasing.

As he put it, "*confidence is growing more fragile and could collapse at any time…".* He noted that *"as a nation we are consuming 6 per cent more than we are producing",* and concluded*: "there is no longer any official support for existing policies"*, which is about as close as an official can come to saying the game is up.

The government took action but not enough.

In 1976, the party came to an abrupt end, with sterling falling and more to the point the government finding it increasingly difficult to fund itself.

The IMF were called in in September with Denis Healey having to return from the airport (where he was on the way to the IMF autumn meetings in Manilla) to speak on the floor of the Labour Party Conference.

This represented the turning point in economic policy as much as Margaret Thatcher's election three years later.

As Jim Callaghan told the Labour Party Conference that autumn: "*We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists, and in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step."*

The government cut spending and introduced cash limits. It also introduced targets for public borrowing and monetary aggregates.

In many ways, 1976 was the culmination of a number of previous crises, connected with the country wanting to consume more than it could produce.

Britain had entered the post war period with huge debts, which the Americans were reluctant to subsidise. It still had the responsibilities of empire and the associated costs but with precious few benefits.

Moreover, it continued to want to play a role on the world stage: Britain decided to build its own nuclear deterrent in 1947 (at a Cabinet Committee meeting at which the Treasury wasn't represented); and, after the US, was the next biggest external provider of troops to the UN force in Korea.

But at the same time the war had led to higher expectations about a better life. There was huge popular demand for the state to provide better public services and welfare payments, in particular the NHS and national insurance-based pensions. And the public was happy to vote for a party which was prepared to nationalise the commanding heights of the economy.

The country was effectively living beyond its means: a recurring theme.

The shortage of foreign exchange led to chronic shortages. Rationing was only abolished in 1954.

Britain devalued in 1949, with sterling's value reduced from $4.03 to $2.80.

But Britain was locked into a Bretton Woods system which Maynard Keynes had been instrumental in creating. Reflecting Britain's usual staying power when it comes to economic policy anchors, it was already beginning to be questioned by the early 1950s. A secret project codenamed Robot almost led to the UK floating Sterling in 1952.

However, the government decided to stick with fixed exchange rates. And, although Britain grew faster in the 1960s and 1970s than it had ever done before, structural rigidities meant that productivity growth lagged behind its main industrial competitors.

Government made the mistake of turning the exchange rate parity into a test of credibility. When the then Labour Government devalued from $2.80 to $2.40 in 1967, its credibility never recovered.

So where does the 2008 financial crisis fit into this paradigm?

In one sense it was an external shock.

Had the packaging of sub prime mortgages not become fashionable in the United States, it might not have taken the form it had.

But it took the European banks to buy such instruments.

And it required the British banking system more generally to jump on the bandwagon of providing mortgages at loan to value ratios of over 100 per cent.

That in turn involved the regulators' misunderstanding the risk building up in the system. There has been a lot of rewriting of history over the last ten years: but the speeches emerging from the Federal Reserve, Bank of England and Treasury in the early to mid-2000s speak for themselves. The fact is there was a massive collective intellectual error.

And – although it's unfashionable to blame the British people – the crisis was also permitted by consumers also taking the view that they could live beyond their means.

Of course, when the crisis struck, the British state did a reasonable job in responding. The lessons learnt from the mishandling of Northern Rock had been learnt. By late 2008, the Bank was no longer talking about moral hazard. Mervyn King did what was necessary to pump liquidity into the system. And the Treasury had in place the necessary legislation to make immediate intervention possible whether in relation to Bradford and Bingley, the Icelandic banks or Royal Bank of Scotland. We had also learnt the lesson that you don't need to pay large fees to investment banks to take over a bank. Rather – provided you had good legal advice – you could do it yourself…in the middle of the night. And whatever else you think about Gordon Brown, he did a fantastic job in the autumn and winter of 2008 in coordinating interventions internationally – he showed real leadership. But we should also be in no doubt that the consequences of that crisis live on.

The banking crisis destroyed a huge amount of taxable capacity, in particularly in the financial service sector. That capacity has never come back. And it is for that reason – rather than a loss of public expenditure control – that the deficit rapidly expanded, reaching £150 billion by 2010. Whether or not "austerity" measures on a scale implemented by the coalition government were necessary remains a matter of debate. But fiscal consolidation was necessary.

You cannot run a deficit of 10 per cent of national income for any length of time without putting pressure on your exchange rate and borrowing costs.

Alistair Darling recognised this in 2009 though it fell to George Osborne and the coalition government to do the heavy lifting. And Philip Hammond should be congratulated for handing over the public finances in such a good state when the May government finally fell this summer.

But perhaps more importantly the impact of the financial crisis lives on in stagnant real wages and productivity. Output per hour rose by 26 per cent between the last quarter of 1997 and the last quarter of 2007. Since then it has grown just 2 per cent. Workers have experienced a similar slow down in real wages. And perhaps more than any other factor this explains Britain's vote to leave in the European Union.

With Brexit potentially just 22 days away, I feel obliged to say a few words on its impact. So far it has generated a political crisis rather than an economic crisis. That could change in the weeks ahead though if Government and Parliament can reach some sort of deal with the European Union it needn't.

But in some ways Brexit's long-term effect could prove more malignant. Economic crises by their nature are visible. The currency collapses.

Or gilts become friendless in the market. Or there's a sharp rise in unemployment, or fall in living standards. Or all of the above.

If the Government handles Brexit sensibly, and that is a big if, the impact of Brexit is likely to take something like 1/4 to ½ per cent a year off annual growth in productivity and living standards. That is barely perceptible. But over a ten to twenty year period, it could have an effect much bigger than any of the crises I have described today. Indeed, only this week, Chris Giles of the Financial Times has estimated that Brexit has already reduced GDP by 2 to 3 per cent compared to the counterfactual. According to my reckoning that will be resulting in a loss of revenue to the Treasury of some £20 billion a year. And yesterday's forecast from the IfS provides further food for thought.

But that's enough on Brexit.

I would like to end by setting out what I see as the main lesson from this brief tour through Britain's economic crises?

First, you should **never get too obsessed with a particular orthodoxy**. And you should always be prepared to question the regime in place however much the consensus is in favour of it.

Future Chancellors may want to follow George Osborne's example in 2012 or 2013: appoint a devil's advocate – in that case, a young Treasury official with first hand experience of Japan's "lost decade" – to argue against the prevailing orthodoxy in meetings with the Treasury high command.

Second, **Britain has generally been good at pulling back from the brink**. Yes, it has gone closer to the cliff-edge on rather more occasions than other medium sized economies.

But when it gets there, it generally deals with the matter in hand, and recalibrates whatever orthodoxy it has been following. Normality tends to return.

Of course, being good at crisis management should not deflect you from the even more important objective of not getting into a crisis in the first place. Or to put it another way we should value professionalism over gifted amateurism.

My third point is that the British people and the politicians they elect tend to have **a bias in favour of consumption and borrowing over savings and investment**. That's OK up to a point: consumption supports demand. But it explains why we tend to have a higher national debt, less investment and worse infrastructure than some of our competitors.

Voters expect their wages to rise. They expect their house prices to rise. They expect decent public services.

But they prefer not to pay for them. Politicians tend to pander to these somewhat contradictory positions. This is why historically booms have tended to go on just a little too long. And why voters tend to get a bit restless when their needs are not met.

My next conclusion is that **large and deep capital markets are both a blessing and a curse.** When financial crises hit like in 1914 or 2008, the country tends to be affected more than most. But when credibility is restored the ability of the country to access the funds it needs minimises potential dislocations. One of the reasons Britain was on the winning side in the First World War is that – unlike Germany – it did not run out of money.

That takes me on to my next point which is that **institutions matter**. The rule of law matters, as does the strength of the Bank of England and H M Treasury. These institutions may get things wrong: going back on to the Gold Standard in 1925, joining the ERM in 1989 or allowing risk to build up in the mid-2000s. But they have the capacity to adapt and learn from their mistake. Britain has not defaulted since Charles II's Stop on the Exchequer in 1672. To this day, the Debt Management Office is probably one of the most efficient auctioneers of debt in the world.

It's interesting that those institutions have been under continued attack over the last two years. Such attacks will impose a price.

Next, **leadership is important**. One of the problems in the UK in the last two years of the May government was the complete absence of leadership. The current Prime Minister is seeking to fill that vacuum, albeit somewhat idiosyncratically.

Lloyd George's response to the banking crisis of 1914, Callaghan and Healey's efforts to make the Labour Party see sense in 1976 when we went to the IMF and Gordon Brown's in 2008 demonstrate that some one needs to take charge in a crisis. And if they do, they can make a real difference.

Finally, you can **learn from a crisis**. I do not endorse everything the Bank of England or Treasury has done since 2008: the authorities have spent too much time refighting the last war rather than focusing on the next. But I am in no doubt that the banking system is now much safer. And the public finances are in a much better place.

All of which is a long way of saying that history matters.