

**World Economy and Finance Programme Conference: “Picking up the pieces”,
28 January 2010.**

The financial and economic crisis of the past three years has posed huge challenges to policy-makers. Before the crisis broke, the UK economy had experienced a prolonged period of macroeconomic stability, characterised by steady growth, low inflation and with unemployment maintained at much lower levels than had prevailed in the 1980s and early 1990s.

As you will recall, there was a lively debate regarding the reasons for this “Great Stability”, with differences in view over the extent to which it improved policy or simply good luck. This debate wasn’t exclusive to the UK, although here some of the changes seemed particularly marked.

Nonetheless, the environment changed dramatically as the financial crisis took hold, and policy-makers have had to adapt in response. This required radical departures from previous practices. Large-scale interventions were required to avert the collapse of the financial sector, including the provision of liquidity, provision of state guarantees for financial sector liabilities and in a number of cases partial or wholesale nationalisation of financial companies. The threat of debt deflation and balance sheet recession was countered by very large increases in fiscal deficits and the adoption of quantitative easing. In framing this response, we had to recognise that we had entered a new paradigm, in which policy prescriptions that were appropriate in the context of macroeconomic stability were no longer optimal. In this people sought to draw lessons from the 1930s, previous recessions and the more recent experience of Japan.

An important element in our response has been to allow fiscal policy to support demand, and thereby help to stabilise the economy. This has occurred both through the automatic stabilisers, including maintaining the level of nominal public spending, and through discretionary measures, including the bringing forward of capital spending and the temporary reduction in VAT. The corollary of that response has been an increase in the public sector deficit to over 12% of GDP. The Government has recognised that deficits of this scale cannot be maintained for long. The challenge going forward is to determine the appropriate timing and pace of fiscal consolidation, together with the composition between tax and spending measures. This is an area where policy-makers can benefit from further academic research.

A second important issue is how the crisis has affected the supply-side of the economy, and in particular the level of potential output. This is a critical issue for the Treasury, as it determines the decomposition of the deficit between permanent (or structural) and temporary (or cyclical) components. Since the end of 2008, HMT has assumed the crisis would have a substantial negative impact on UK potential output. In the Pre Budget Report projections at the end of last year we estimated that the trend level of output could be permanently lower by 5%. But such estimates, based in part on historic experience, will need to be assessed in the light of actual experience. Again this is an area where we can usefully draw on insights and analysis from external researchers.

Over the past year, monetary policy has been implemented through quantitative easing. This has taken policy into unfamiliar territory, drawing on economic principles. Along with the fiscal expansion and financial sector interventions it has

helped to avert the risk that a deflationary spiral could develop, which could have seriously exacerbated the economic distress. This has helped to underpin confidence in financial markets, reflected in the strong recovery in equity and corporate bond markets and high levels of corporate bond issuance in the past year.

The development of the crisis has highlighted the need to strengthen our understanding of the interactions between financial markets and the real economy, including whether we can improve our ability both to detect and to prevent the build-up of systemic risks. This provides a rich area for further analysis, including of the effectiveness of macro-prudential policies. The debate would benefit from some academic clarity over objectives and instruments and how they might interact. Indeed, to me parts of the debate people seem to assume that because a problem has been identified so has a solution. We know however, some of these issues are very difficult. An important challenge is to design policies that are robust to financial innovation, and that genuinely reduce systemic risk rather than simply displacing it into shadow financial sectors.

Finally, the crisis has also put the spotlight back onto international co-ordination of policies, a topic that has received less attention in recent years. The crisis has been a good illustration of some of the issues here and it's been something the UK Government has sought to promote, including through its G20 Presidency last year. Here too, further research both on the benefits of more active co-ordination and the political economy of the institutional arrangements that could promote it would be of value.

In conclusion, the events of the past three years have highlighted areas where we need to deepen our understanding of the ways that stress can build in financial markets, and of the interaction between financial markets and the wider economy, and of the policy responses that can mitigate these pressures. This provides a rich research agenda for the future which I'm sure the ESRC will want to contribute to.