

Conservatives

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Osborne: Policy making after the crash

Addressing the RSA, Shadow Chancellor George Osborne, said: check against delivery

“Thank you for inviting back here to the Royal Society for the Arts.

I am pleased that we are engaging with your policy team on a wide range of issues.

Two years ago, I gave a speech in this room on ‘open source politics’, and how the internet and new forms of social media are changing politics and government.

Many of the ideas I raised in that speech, from using search technology to throw a spotlight on government spending to using open source IT, are now Conservative Party policies – and, in the case of greater spending transparency, now implemented by the Mayor of London.

Of course, since then – to put it mildly – a lot has happened.

The financial crisis has led to deep recession and staggering deterioration in the public finances.

The politics of prosperity is giving way to the politics of austerity.

The crisis has also exposed two fundamental arguments.

The first is whether, when you are already borrowing too much, you should deliberately try and borrow your way out of debt.

David Cameron and I have consistently argued against this irresponsible course of action.

To begin with we were almost alone in making this argument, but we held our nerve and stuck to our principles.

And now informed opinion has turned in our direction – the Governor of the Bank of England made it crystal clear that he agrees with our position that Britain cannot afford a second fiscal stimulus, and today even the Prime Minister appears to be in full retreat.

The forthcoming Budget will mark the collapse of his strategy for dealing with the recession.

And it will vindicate the principle of fiscal responsibility that we Conservatives have stood by in good times and bad.

Having won the first big argument, we must now take the second head on.

There is a view emerging on the left is that the financial crisis is also a crisis of markets in general. In Britain, it is evidence of the shift from the centre ground we see taking place in the Labour Party.

I understand that the public feel disillusioned, betrayed and angry about financial markets.

After all they spent a decade being told we had arrived at a financial nirvana of stability and growth, only to find it was just a fragile illusion of prosperity built on debt.

But the view that this crisis heralds the end of market economics is profoundly mistaken.

It needs to be confronted and defeated.

Despite the scale and severity of this crisis, the economic contraction taking place will not undo the awe inspiring increases in living standards that open markets have facilitated in much of the world over the last thirty years.

China's market reforms that began in the early 1980s and India's opening to trade at the beginning of the 1990s have done more to raise the living standards of more people than any other government policy in the history of the world.

Abandoning that progress or turning our backs on open markets would be a tragedy.

It would return hundreds of millions to the dollar-a-day subsistence poverty out of which they have been lifted.

That's why we need to maintain the pressure for further liberalization of world trade in the face of the protectionist backlash.

Many extend the argument that what we are seeing is crisis of markets in general to argue that it has also created an existential crisis for parties of the centre right, traditionally the champions of market economics.

Of course this is a convenient argument for centre left politicians in Britain who find themselves confronted with the inconvenient truth that they are the ones who have been in office for twelve years, but it too is deeply flawed.

Not only is the centre left's case that now is the time for big government solutions holed below the waterline by the new central fact of British politics – that there is no money to pay for them.

In Britain at least, it is based on a straw man – the idea that the Conservative Party believes in laissez faire capitalism.

We do not. We are a Conservative Party not a libertarian party.

As both I and David Cameron have argued, Conservatives have always understood the limitations of free markets on their own.

We understand that unless markets are embedded in strong institutions, laws and cultural norms they can become free-for-all that are prone to instability and end up benefitting the powerful at the expense of the needy.

Indeed, many of the problems we face today have been exacerbated by the weakening of many of those institutions – not least the Bank of England.

Today I want to explain how modern economic thinking and research underpins the Conservative approach to policy making after financial crisis.

And I want to look beyond the current debate on regulation to highlight three ways in which we must avoid sowing the seeds of the next crisis in the solutions to this one.

Underlying our approach are two crucial insights into the limitations of markets – one old and one new.

The old one is that individual rationality does not ensure collective rationality.

And the new one is that even individual economic behaviour is not always entirely rational.

Far from being a radical rejection of markets, these insights are now the foundation of modern free market economics – the result of decades of research and policy errors.

Consider the idea that individual rationality does not ensure collectively rational outcomes.

Traditional Keynesian macroeconomics had little to say about individual behaviour.

That's one reason why it and the active demand management it prescribed were killed off by a combination of the stagflation of the 1970s and Robert Lucas's rational expectations revolution.

His Nobel prize-winning insight was that economic agents would not be fooled by the Government's persistent attempts to reduce unemployment by pumping up demand – instead they would just expect prices to rise and the only result would be more inflation.

Lucas showed that economic models which were not based on understanding the behaviour of individual economic actors would break down when used to predict the effects of policy.

So just because pumping up demand worked the first time a government tried it did not mean it would work again – people would get wise to it and adjust their expectations accordingly.

But rational expectations posed a problem of its own – why did markets made up of rational agents sometimes result in outcomes like mass unemployment that nobody would ever choose?

The eventual result was what became known in the academic literature as New-Keynesian economics, though it had very different policy prescriptions from those of John Maynard.

Agents in most modern macroeconomic models have rational expectations, but simple and realistic market imperfections mean that when their actions are aggregated the results can be far from rational.

So seemingly harmless assumptions – such as the possibility that prices and wages might be sticky and not respond immediately to changes in costs or demand – can result in persistent unemployment.

Models of this kind underpin our whole macroeconomic policy framework – in particular the idea that by using monetary policy to manage demand and control inflation you can keep unemployment low and stable.

And they underpinned the argument David Cameron and I advanced last autumn – that monetary policy should bear the strain of stimulating demand – an argument echoed by the Governor of the Bank of England last month when he said that “monetary policy should bear the brunt of dealing with the ups and downs of the economy”.

We now appear to be winning that argument hands down.

The idea that individual rationality does not necessarily ensure rational outcomes is also a feature of many models of financial markets.

Keynes himself famously likened investing in financial instruments to a beauty parade where competitors have to choose the faces they think will on average be found prettiest by the other competitors.

His views may have something to do with the huge amount of money he lost in the 1929 stock market crash, but modern economics has now developed sophisticated models of “rational bubbles”, where imperfect information or misaligned incentives can lead rational investors to drive prices far away from their fundamentals for a prolonged period.

The effects are magnified when they are combined with a second and more recent development in modern economics– the understanding that individuals themselves might not always act rationally.

This is known as behavioural economics.

It challenges the assumption that the economy is built from the rational calculations of millions of members of the species whom Professor Richard Thaler calls 'homo economicus'.

It is a curious species.

Homo economicus maximizes profit in every human encounter.

Homo economicus never does anything for love or honour or pride or pig-headedness.

To homo economicus, everything has a value and nothing is priceless.

In fact, you wouldn't really want to meet homo economicus.

But so much bad policy design has been based on the assumption that that is who we all are.

Take the way the tax credit system currently operates, for example.

It was designed on the assumption that people would immediately inform Revenue and Customs of any change in their income.

That was a rational assumption in the sense that if people didn't inform the authorities, they would either lose the benefits they were entitled too or be over-paid and face having money clawed back from them.

So why wouldn't people?

It must have seemed so plausible on a spreadsheet on the then Chancellor of the Exchequer's desk.

But of course, as it turned out, people don't quite behave like components of a Treasury model, and it is a shocking truth that millions of our fellow citizens failed to do as they were told.

As a result, billions of pounds of taxpayers' money has been lost on overpayments, and hundreds of thousands of families have been dragged into hardship as payments were clawed back.

This policy failure wasn't primarily due to administrative or IT errors, although they certainly amplified its effects.

It happened because the policy was designed on the assumption that people always act rationally and in their best interest - an assumption that continues to be at the heart of much government policymaking today.

Yet over the last decade social scientists have challenged this worldview in many ways.

Nobel Prize winners Amos Tversky and Daniel Kahneman, for example, have shown that the way in which a choice is presented can dramatically effect the decision making process.

For example, people told that an ice-cream is '90 per cent fat-free' are far more likely to agree to a second scoop than those who are told it contains '10 per cent fat'.

And patients are more likely to agree to an operation if they are told that 90 out of 100 people survive, rather than 10 out of 100 die.

This phenomenon is known as 'framing', and if people really were rational, it wouldn't exist at all.

Another challenge to the assumption of individual rationality comes from MIT professor Daniel Ariely's work on what is known as 'anchoring'.

His insight is that we tend to attach weight to initial prices that, once implanted in our minds, shape not only present prices but also future ones.

In one of his most famous experiments, Ariely asked a group of people to write down the last two digits of their social security number.

He then asked them to submit mock bids on items such as wine and chocolate.

Those with high two digit numbers submitted bids between 60 percent and 120 percent higher than those with low numbers.

It appears that the simple act of thinking of the first number strongly influences the second, even though there is no logical connection between them.

In the literature, framing and anchoring are known as psychological heuristics – rules of thumb that people use to make decisions, particularly when under pressure or given limited information.

The Conservative Party has been making the most of these new policy insights to design better policy in many different areas.

For the past 18 months, we have been working with Richard Thaler, Robert Cialdini and others to develop new social policy that more effectively reflect how people really behave.

So because we understand the importance of how a decision is framed, we have been working with some local authorities who are going to try paying the public to recycle by taking some of the money saved on the landfill tax, instead of fining them for not recycling and seeing the litter mount up.

Similarly, because we realise that people often make bad personal finance decisions when they're excited by the prospect of immediate gratification, we will impose a seven day cooling off period for store credit cards, so shoppers can't immediately rack up debts on them when they sign up at the till.

And because we understand that people are influenced by the people around them, we will require electricity companies to put comparative information on bills, so that households can compare their energy consumption with similar homes.

We know from California that when people are given this information, and find out that they're using more electricity than their neighbours, they quickly take action to become more energy efficient.

But it's now painfully clear that perhaps the most important impact of these sorts of deviations from individually rational behaviour has been in financial markets.

Non-rational behaviour can exacerbate the tendency of financial markets to reach collectively irrational outcomes.

This insight lies behind Robert Shiller's "irrational exuberance" and Hyman Minsky's argument that financial markets are inherently susceptible to speculative booms which, if long lasting, are likely to end in crisis.

Of course it's easy to point to these theories after the event – once the system has already collapsed.

The important thing is to admit mistakes and learn the right lessons so that we can minimize the chances of it happening again.

How should we manage financial markets if individually rationality does not ensure collective rationality, and if even individuals are not always rational?

Some of the regulatory answers are now emerging.

Conservatives argued more than a year ago that in future banks will have to hold more capital through the cycle, that capital rules should be made counter-cyclical instead of pro-cyclical, and that complex derivatives should be traded through clearing houses.

And as we saw at the G20 summit, there is international agreement on the need to eliminate destabilizing remuneration policies that encourage short term risk taking at the expense of long term results.

All of these reforms would dampen the irrational exuberance of markets and limit the damage when bubbles burst.

I am glad that they are now at the centre of the debate.

But today I want to look beyond the current debate on regulation to highlight three ways in which we must avoid sowing the seeds of the next crisis in the solutions to this one.

Because, if our solutions are based on the same simplistic economics that got us into this mess, they are likely to be only temporary sticking plasters.

So we need solutions that are robust to market failure and irrational behaviour by market participants.

First, we need to understand the deep macroeconomic roots of bubbles and financial crises.

Gordon Brown claims that our economy was fundamentally sound when it was hit by a banking crisis that came out of the blue from America.

It is not a view widely held, even by the Americans.

It is certainly not the conclusion of Lord Turner's recent report.

For what went wrong in our banks was a reflection of fundamental imbalances that were allowed to build up throughout our economy over a decade.

British banks became amongst the most indebted, most leveraged in the world, with tangible assets thirty nine times tangible equity compared to seventeen times in US banks.

As an economy we weren't saving enough to fund this debt, so British borrowers – individuals, companies and the government – sucked in hundreds of billions of pounds of loans from abroad.

The result is that our economy was more dependent on debt than any other major economy – personal debt, corporate debt and government debt. In short, as a country we lived beyond our means.

Our banks borrowed money from China to lend to us, so we could buy the goods the Chinese produced. We could see it in the huge current account deficit that persisted for a decade.

As Adair Turner put it, "rapid credit extension was underpinned by major and continued macro-imbalances, with the UK – like the US – running a large current account deficit and with domestic credit expansion thus financed at the aggregate level by the willingness of overseas investors to extend credit to UK counterparties"

We need to challenge the idea expounded by Alan Greenspan, and adhered to by his admirer Gordon Brown, that it is difficult to spot these credit-fuelled asset booms and impossible to do anything much about them except mop up the damage when they go bust.

For it turns out there is a lot of mopping up to do.

Instead, as American economist Robert Shiller has shown, what we should aim to do is identify debt-fuelled bubbles as they grow and take action to limit their size.

He has found that financial market prices can diverge substantially from estimated economic values for long periods of time.

These divergences can be so large, Shiller argues, that it is reasonable in these situations to conclude that market prices have become irrational.

The question is: who can reach that reasonable conclusion?

Not a micro-prudential regulator, focused as it is on individual firms, who might struggle to see the wider picture.

However, the Bank of England could.

But that means accepting that the current tri-partite regime needs radical change – something you would have thought obvious after the mistakes of the last eighteen months, but something the Prime Minister refuses to do.

Conservatives do accept the need to change the existing tripartite regime. We propose giving the Bank of England a new responsibility to supervise the overall level of debt and credit growth in the economy as a whole.

That is one way to spot debt-fuelled bubbles before they burst, and try to deflate them gently.

And there may be a case for conventional monetary policy to be more responsive to asset prices too.

As I've argued before, I don't think it's sensible to use interest rates to target asset prices directly – the danger is that in using one tool to hit two targets means missing both and so you end up with more volatility in the real economy, not less.

However, there is considerable debate about whether the current CPI inflation target reflects the true cost of living faced by consumers, and whether the target should be broadened to include housing costs, which were included in the previous RPIX target.

Gordon Brown changed the inflation target in 2003, but in little-noticed evidence to the House of Lords a few weeks ago Mervyn King made it very clear that this made the Monetary Policy Committee's job more difficult:

“Certainly in the last two or three years, before the crisis began in 2007, it is fair to say that the change in the target probably made it more difficulty for us to achieve that balance... I think it would have been preferable have we stayed with an index in which House prices were still included.”

The European statistical authorities are currently debating how housing can be added to the Consumer Price Index in a way that is consistent across the EU.

But given that we are not a member of the Euro, we don't need to be bound by a timetable that may take many years.

As I said last October, it would be wrong to change the inflation target right now given the fragility and uncertainty in the financial markets.

But a change of government would provide a sensible opportunity to review, with the Governor of the Bank of England, what changes would be appropriate so that housing costs are properly reflected.

If the first way to avoid repeating the past mistakes of irrational markets is to try better to manage the credit cycle and spot the booms.

The second way that we can reduce the risks of sowing the seeds of the next crisis is by understanding the limits of relying solely on hard, inflexible rules to control markets.

The new faith in perfect regulation is as naïve as the previous faith in perfect markets.

Of course new rules – especially on capital and liquidity – will play an important part, but experience teaches us that no rule is flexible enough to deal with every situation.

People will often find a way around rules through regulatory arbitrage and new financial instruments.

Just as the Lucas critique applies to economic models that are not based on a proper understanding of how people behave, Goodhart's law applies to targets and rules that are not flexible enough to respond to innovation.

This law, named after Professor Charles Goodhart, states that any indicator that is used as a target for policy stops containing the useful information that qualified it for that purpose in the first place.

So just as low and stable consumer price inflation stopped being a sufficient indicator of macroeconomic stability over the last decade, it's possible that the same will happen to the sorts of financial targets now under discussion.

For example it is possible that banks' leverage ratios will no longer be a good measure of financial risk if they are subject to strict controls.

That doesn't mean they shouldn't be controlled.

But it does mean that where strong regulation is needed – as in financial markets – rules must be supplemented by powerful institutions who are empowered to use their discretion when necessary.

The Bank of England needs to be one of those powerful institutions.

It used to be said that one twitch of the Governor's eyebrows was enough to force unruly bankers into line – well we will give the Governor back his eyebrows in a way that suits modern financial markets.

That means locating the macro-prudential regulator in the Bank, not the FSA as Lord Turner argues.

And it's why we are considering the option set out by Sir James Sassoon, in the review of the tripartite system I asked him to conduct, of giving the Bank back-stop powers to step in over the head of the FSA and impose its will on individual financial institutions if financial stability is threatened.

The third and final way that we can reduce the risks of sowing the seeds of the next crisis is by reducing the costs when regulation fails.

Because we cannot really understand what went wrong over the last decade without being clear that it wasn't just a failure of markets – it was also a massive failure of government policy and regulation.

After all, the banks were the most regulated institutions in the whole economy.

In Britain the problem was partly that the regulators focused on the wrong things – ticking boxes instead of challenging unsustainable business models and monitoring the overall levels of debt in the economy.

But in many cases policy actually made things worse.

So the internationally agreed Basel capital rules actually exacerbated the credit cycle because they allowed banks to treat their assets as if they were better quality than they actually were.

The reliance of the whole system on the credit rating agencies meant that the errors were highly correlated across institutions and assets, violating one of the key assumptions of the underlying economic models.

And in Britain the Government's fiscal rules exacerbated the boom by allowing spending and borrowing at unsustainable levels, leaving us badly exposed.

Of course all rules are imperfect, and even strong regulators are sometimes subject to the same inconsistencies and irrationalities as other market participants, so it is safe to conclude that regulatory failure will one day happen again.

That's why it was so hubristic and damaging for the Prime Minister to claim he had abolished boom and bust.

We need to make sure that no future government can borrow in a boom and leave us so badly exposed in the bust.

That's why we will create an independent Office of Budget Responsibility to act as a rod for the back of all future Chancellors.

But we also need to reduce the costs to the rest of the economy of regulatory failure in the financial system.

We cannot allow one part of our economy to behave in a way that puts the rest of the economy at risk when it fails.

We need to think deeply about whether we can sustain banks that are not only too big to fail, but potentially too big to bail.

That's why I believe Gordon Brown is wrong to have ruled out at this early stage more fundamental changes to the future structure of the banking industry.

The case for change has now been made by Paul Volcker, Nigel Lawson and the Chief Executive of Bank of America, and the Governor of the Bank of England himself has called for "a public and informed debate" on the issue, so it cannot be dismissed out of hand.

Whether any form of separation between retail and investment banking, even within the same financial group, is feasible or desirable, it is clear that size itself is a risk factor.

Not only do large financial institutions do more damage when they get into trouble, but their very size and "too big to fail" status may encourage them to behave irresponsibly and take risks that smaller banks dare not take.

And John Fingleton was right yesterday, when launching the OFT's review of the financial services sector, to highlight the reduction in competition between banks as a consequence of the financial crisis as banks merge and lenders withdraw from the market.

In the long term, whilst tighter regulation can strengthen financial stability we need to balance this with need to maintain and enhance competition between banks and others to protect consumers.

By dint of its substantial shareholdings the Government has a powerful influence over the future structure of the UK banking industry, whether it likes it or not.

When the time comes to sell off those shareholdings we need to think very carefully before simply selling them to the highest bidder without thinking through the consequences for the wider economy.

We should look at whether Britain in fact needs smaller banks.

For it would be a bitter irony if we came out of this crisis with a banking system that was even more concentrated and even riskier than the one we had before it.

So, to conclude.

Having won the argument on fiscal responsibility, we now need to win the second great argument thrown up by this crisis.

The failure of the financial markets does not speak, as many on the left believe, to a wider crisis of confidence in the free market.

Instead it reminds us of the insights of much recent economic thinking.

Markets can behave irrationally. The people who make up markets can behave irrationally.

This isn't a failure of capitalism, it is a feature of capitalism.

The issue is how do we design policies and systems of regulation that take this into account and anchor responsibility at the heart of our economy.

In finance, where as we have seen the irrationality can do damage on a staggering scale, it means:

- actively searching for debt-fuelled asset price bubbles and then trying to deflate them gently;
- recognizing the limits of rules alone, and ensuring that we can also benefit from the discretion and judgement of strong institutions like the Bank of England; and
- seeking to minimize the collateral damage when regulation fails, as it inevitably will, by looking at smaller banks.

In other words, while fighting the current crisis, making sure we don't sow the seeds of the next one."

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