Title *Challenging Macroeconomics*
Description In part 6, our experts examine new models for monetary and fiscal policy, global financial markets and a world economy characterised by global imbalances.
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Part of series *The Credit Crunch and Global Recession*

Linda Welcome to the last podcast of this series for this academic year.

We're going to take an opportunity to look back on a year of this economic crisis and reflect on the ways in which it will reshape the way we think about certain economic theories and models, as well as how it is that we regulate markets.

So once again I'm Linda Yueh. I'm a fellow in economics at St Edmund Hall in the University of Oxford and my new book comes out this month: 'The Law and Economics of Globalisation: New Challenges for a World in Flux'.

Jonathan My name is Jonathan Michie. I'm President of Kellogg College at Oxford. My books on globalisation a couple of years ago foretold many of the problems we're now suffering from.

Martin I'm Martin Slater. I'm tutor in economics at St Edmund Hall.

Linda Shall we start by thinking about some of the big debates which have come about as a result of this crisis in terms of the way that central banks do their business of running monetary policy.

So one of the big issues that's come up is should the bank take on more of the regulatory functions that, for instance in Britain, the Bank of England had before it was made independent in 1997?

Are we going back towards a model in which central banks shall no longer just target inflation in the way that they manage the monetary system but rather take on regulatory functions and also look at asset bubbles?

Jonathan I would say that there's two points there, both of which are important.

Firstly on the role that the central bank should play in regulating, the obvious point to make is they couldn't possibly have done any worse than the people who were actually in charge. And Gordon Brown said that the light touch regulation he'd been boasting about during his ten years as Chancellor didn't mean soft touch regulation. But I think it's clear to everyone now that that's precisely what it did mean. It had been soft touch regulation.

So I certainly don't think there will be any problem going back to that previous regime.

The other point though is about what the authorities should be targeting. Should it just be inflation or should it be employment growth, other factors? And there I think there's no question. It makes

sense to take a rounded view of all the factors together. It's quite wrong just to target inflation on its own. It just doesn't make sense just to look at that one factor like that in isolation.

In addition to those two points, I'd make one other, which is that we should also go back to reintroducing some of the regulations which were swept away because they were thought to be unnecessary. Regulations which had been introduced quite deliberately over the years during the 1930s, '50s, '60s in order to stabilise the global economy and national economies precisely to avert the crises we're now suffering from.

And because people thought that lessons had been learned, that there would be no returns to 1930s, the long post-war boom seemed to be more or less stable despite one or two relatively short-run recessions. But in retrospect I think that there clearly was good reason for having separated the investment banks from the other high street banks and that should be followed again.

But also the fact that there were controls on short-term movements of finance across the world for purely speculative purposes, there was good reason for having that. And the fact that all those exchange controls were abolished during the 1980s and '90s obviously made a lot of money for quite a lot of people but didn't really serve - I think we can now say in retrospect - any great economic purpose.

And I think there's a strong argument for reintroducing some of those controls on short-term speculative movements of capital.

Martin Yes. I think as well as the question of different possible targets, of course if one is going back to older methods of central bank operation one goes back to an era where, indeed, central banks didn't operate according to laid down rules, which, of course, became very popular from the 1970s and '80s onwards.

But a lot of the power of the Bank of England in the past was that the bank authorities had quite a lot of discretion, indeed, to produce certain surprises to the private sector, which was part of their armoury.

And, of course, that has very much disappeared in recent decades, that the central bank is supposed to be entirely predictable, following some kind of prescribed rule. And that may well be something that people would want to consider a bit more in future.

Linda I think, Martin, that's the timing consistency problem, isn't it?

Martin Well, yes, indeed. This all goes back to Kydland and Prescott and people like that. And obviously there are some advantages in this but there are always advantages and disadvantages.

But, as Jonathan was saying, that a lot of the move to reduce the number of controls, like exchange controls and other kinds of more direct intervention into what banks were doing, were, of course, thought to be advantageous in themselves... removing those controls at the time.

So there's a balance of advantages. There's obviously no way in which there's some kind of perfect regulatory system that would avoid all problems but I think clearly the most recent system where we've had a highly constrained central bank engaged in targeting really own one variable has found to be rather lacking.

Linda I'd agree with that. I think when the central banks really moved towards independence in the early 1990s they coincided with this global period of very, very benign inflationary conditions.

So throughout the '90s and the noughties there was quite a claim about how it was that it was the reconstituted central banks which were the reason for the great moderation, the very benign business cycle, the strong inflationary environment.

And I think to a certain extent central bankers were misled by the fact that inflation remained so low while growth was so strong. So they never felt the need really to raise interest rates because the macro factors they looked at seemed to be so benign.

But actually what was happening was emerging markets around the world - China, India, Eastern Europe shedding communism - rejoined the global economy and they had a very strong deflationary effect on manufactured goods prices which then put downward pressure on import prices pushing down inflation in the rich economies.

So while the central banks were targeting that, I think in many ways they missed the fact there was a lot of liquidity in the system and because they controlled the price of money by setting interest rates, it was a lot of liquidity on the basis of very cheap credit and cheap money.

And when this money began to get fuelled into the housing market in the United States, the buy-to-let market in the UK and, of course, funding wholesale money markets which then projected this liquidity throughout European markets, I think there is a link to what central banks were looking at and the result, which was, in Alan Greenspan's phrase, keeping interest rates too low for too long.

So I think looking ahead there must be a good argument for thinking about having a much more open or global set of variables to target because asset bubbles are endemic and just sticking to a rigid central bank rule is not enough to actually address that.

Related to this issue of central bank independence, the British Chancellor has stated that even at the European and American level, there is general agreement in principal that we ought to look harder at asset bubbles. But the reality of how you lean against asset bubbles is a lot more difficult.

Jonathan Yeah, but one problem is that the governments obviously in the short term gain from asset bubbles as they manifest themselves in the housing market because increasing house prices can fuel economic growth for several years on end and suddenly some of the apparently strongest economic cycles in recent history have been, in retrospect you can see, actually fuelled not by investment in manufacturing expansion of the traded goods sector and so on but actually growth of house prices that people have taken the value out of by increasing their mortgages and their loans in order to spend on consumer goods.

But, of course, as that's happening, while government takes the glory for having continual economic growth, which is maybe something we should question in any case, but firstly they get the credit for that and, of course, they get the tax revenues from it as well.

Martin There's a political argument which makes suppressing asset bubbles difficult like that. But also I think there's the economic technical problem of just how you do it without creating as harmful effects as a collapse of the asset bubble without intervention at some stage.

And, of course, that indeed very much conditioned Greenspan's view in the past. He was very worried that taking action to stem what might appear to be a growing bubble would actually push the economy into recession at a time when you wouldn't want it.

And again I suppose this comes back to, again, this problem that we just talked about about a very simplistic view where the central bank is really only looking at one dimension of the economy and only has one, or very limited, range of targets.

That will work, so long as your basic model of the economy is a very ideal one in which most things do go up and down at the right time and in line with each other. And the question about whether the economy is overheating or not is an entirely one-dimensional question.

In practice, as we can see, you may find that the economy is overheating in on particular area, i.e. the asset bubble, whereas real employment is still not really terribly solid. And the authorities have this terrible concern that if they actually take steps to dampen down the asset bubble, which normally would be something like an interest rate rise, this, of course, will cause the real economy, which they still would like to encourage, to go down at that point. And, of course, that's something that is a very difficult decision to make.

Linda I would expand that globally. So there's talk about reforming how it is that policy is made. It has to be done at a national level, the regional level - the European Union is an example - and at the international level. So this multi-layer of governance is one of the reasons why this financial regulation debate, this policy debate, is so challenging.

But it occurs to me that even if you came up with a global regulator early-warning system based in the bank for international settlements which warns against asset bubbles building up in different countries as a result of global imbalances - so too much liquidity in the US wholesale money market is causing an asset bubble in China next time - would the Americans really agree to raise interest rates to dampen an asset bubble in China?

I find this to be extremely difficult and I think this international coordination part I think adds another dimension of how, even if they could agree that you needed to guard against asset bubbles, how would this actually work in practice?

Jonathan Well partly I think it goes back to needing quantitative controls as well as price controls and having exchange controls, capital controls. I've heard it described as the current situation, where all the controls are bullish, of trying to carry a tray full of water and as soon as it starts sloshing to one side of course you're doomed and it will all go. And that's precisely why you have buffers in the system, to prevent the water sloshing about the tray or the huge billions or trillions of dollars and pounds sloshing around the globe in a matter of hours.

And during the Asian financial crisis back in 1997, Malaysia was heavily criticised for introducing exchange controls in order to protect themselves from the crisis. And, in fact, they were downgraded by the ratings agencies because had come to believe this myth that you couldn't have these sort of controls anymore. And, in fact, of course, it was successful in protecting the domestic economy at that time.

So I think that is why these sort of controls can be useful. And picking up on a point you were making earlier about the apparently benign situation people were in over the last few years and people getting lulled into a sense of false security, I think, although people had referred to it as globalisation, people hadn't really appreciated the risk that the global economy had been put under by the lack of these controls precisely because the situation's seen to be relatively benign.

And even when the crisis was breaking, the global credit crunch was breaking, there was still a widespread belief that it was a cause and therefore it would be more or less contained to the US, Britain and one or two other countries. But the basic strong economic powers, Germany or China or whatever, wouldn't necessarily be so affected.

But, of course, just the sheer scale of the global financial flows have really disrupted the entire global situation.

Linda One of the other tools which had been used in this crisis by central banks is quantitative easing. This is, of course, very reminiscent of open market operations. This says they control the money supply rather than the price of money, which is interest rates.

Are we going back to the 1980s and '70s then when really money supply, like M2 aggregates were targeted? Or is this something fairly unique to this particular crisis because of the credit crunch so therefore central banks are just bypassing the credit system to directly inject money into the monetary base, into buying corporate bonds and what have you? Or is this another change to monetary policy making looking ahead?

Martin I would think we're going all the way back to the experiments of the 1980s which, of course, had a great deal of problems. The reason they had a great deal of problems was that financial innovation was occurring at quite a rapid rate.

And now any kind of policy which is focused very heavily on quantitative monetary aggregates has this problem of which monetary aggregates you're going to focus on and what are the relationships

between the monetary aggregates, which tend to be changing all the time, and, indeed, tend to change rather faster the more you lean on one particular monetary aggregate as people want to substitute into the other things.

And that, of course, was what happened to the Thatcherite experiment in the UK in the 1980s when they decided to target sterling M3 at the time, which was the their preferred thing. And actually they found that very difficult although overall, I think, people would agree that they did run a fairly tight monetary policy but it wasn't one that was very under their control.

So I think that that's the main difficulty in going back to a quantitative target regime.

But, of course, if we do go back in several other aspects to earlier types of banking, particularly if we start to introduce quite strong regulations about the separation of particular types of banking, this is going back to the Glass-Steagall Act again; indeed suggesting that there are certain banks who produce certain kinds of assets and liabilities and there are other financial institutions that have got rather different assets and liabilities.

And we can then define that there's only this particular narrow group of banks that are actually really involved in producing money, which is what we want to target. This, of course, is the world that the kind of monetary targeter was hoping that they were going to operate in.

So it could be that if regulation goes all the way back to producing fairly rigid controls on what banks and other particular financial institutions can do, then we'll be able to get a rather tighter hold on monetary aggregates again.

But given the possibilities of financial innovation and a lot of flexibility in the financial system that we have had since the 1980s, then it has been quite difficult, I think, to have a very clear view about which monetary aggregate is not too slippery to hold.

Jonathan Yes. And it's important to remember that what's being attempted now with money supply is the exact opposite of what was being attempted by the Thatcher government, who was trying to restrict money supply because it was said that would cure inflation relatively painlessly, it was claimed at the time.

That proved completely false and actually what the policy did was drive up interest rates and the currency became overvalued and both of those together pushed the economy into a very severe recession.

This time it's the exact opposite. They're trying to expand the money supply to get money into the system. But partly, actually for a similar reason because of the interest rates, because interest rates have been cut virtually to zero around the world and yet it's been characterised as pushing a bit of string. It's no good having a zero price for money unless the money's actually available. And the problem is the banks aren't providing the credit because they're trying to recover their own balance sheets.

So I think the important point is it's trying to do the opposite of what the Thatcher government did in trying to expand the money supply, make money available, because the banks currently aren't making it available.

Linda There's been a lot of debate about how it is we regulate systemically important and large banks. Glass-Steagall is one that you mentioned. Another popularly discussed concept is that banks which are too big to fail are just too big.

And I just wondered if we could spend just a few minutes on what kinds of sensible parameters one might put on this issue deriving from the way economists look at it. So trying to step away from the politicians' views on this, which I think are themselves quite divided.

Jonathan Yes. I think there's no question that any economy gets itself a difficulty if the banks are too big to fail and literally can't fail and it's been particularly ironic when the people in charge of

the banks have managed to devise incredibly intricate and very lucrative contracts for themselves which reward themselves for risk. And if they take a gamble, a big risk, the bank makes a lot of money; they've been paid huge amounts in return.

Now, a lot of people would say "That makes some sense provided it's a genuine two-way bet and if they risk bail then they pay the cost themselves personally with a pay cut and the organisation going bankrupt", as the system is supposed to work.

Of course, when you've got banks which are too big to bail it just exacerbates that problem of one-way bets, knowing that actually if it all goes wrong, well the Government is obliged to step in and use hundreds of billions of dollars or pounds worth of our taxpayers money to prop the bank up.

And so I think there's obviously a strong argument in favour of that point about preventing banks becoming too big to fail, preventing them becoming that big if they then have to be rescued.

But also I think that's one of the arguments in favour of separating the two types of banks. The argument being the high street bank that people have the life savings in, individuals have their life savings in, have their small loans in and so on is a relatively safe operation and if something disastrous, unforeseen, goes wrong then there maybe is something to be said for the Government stepping in and keeping that operation going. Whereas the other type of banking operation, which is literally more like a casino operation, should be treated as such and those that succeed, well fine, let them carry on and those that fail, when then they fail.

So I think there's two points really. One is true preventing any monopoly company in any sector getting so big, but also separating out the two types so that you can step in and make sure that the small savers, the mass of the population, can carry on their banking activities whereas the genuine casino-type operations can be treated as such.

Linda Martin, is there a way to do this, to prevent a secondary banking crisis as we've had before?

Martin Well, that, of course, is the, as it were, the counter example to the Glass-Steagall view that if you think about what happened in the 1970s where we didn't have actually the Glass-Steagall Act in the UK but we did have a similar separation at the time. The financial markets were not highly competitive. They were segmented by the Bank of England into banks of different functions. So we had high street banks and we had merchant banks and we had other more specialised financial institutions.

And what happened there was a rather interesting situation where the government at the time began to feel that - for its own purposes it thought that too much money was going into property development at the time. And the Bank of England at that time did have the powder to prevent banks from taking activities that the Bank of England didn't like. And so it gave instructions to the main banks not to involve themselves in this.

And they duly did not actually engage in this business but, of course, what they tended to do, and what the financial system fairly soon managed to evolve, was a system in which the surpluses of the high street banks were simply lent through direct or indirect means to other institutions which were outside the Bank of England's control which did, indeed, put the money eventually into the property development market. And when the property boom eventually collapsed these institutions first went bankrupt and then their bankruptcy, of course, brought into question eventually the high street banks who had lent them the money in the first place.

And this is, of course, one of the reasons why the Bank of England began to move away from this kind of directive regulation because one view put at the time was that this actually produced a situation which was possibly even in some ways more dangerous than the alternative. And that was that the high street banks didn't actually know what had happened to their money. So that came as quite a surprise to them when they found that they were in a particularly vulnerable position.

And that did produce a potentially very dangerous crisis in which one or more high street banks could have gone bankrupt. In those days it was rather more quietly managed and gradually got out of that kind of problem.

But yes, there is that problem with separating functions. Clearly one cannot separate functions completely. There is bound to be some kind of interrelationship between the different parts of the financial market.

The question then is, is it actually better to segment it into, as it were, separate compartments - I suppose might even use the pejorative term silos - where people don't know so much of what's going on?

Or should we have the more recent model of very comprehensive financing institutions which have a foot in all these things and so in principal ought to have a better idea of what their overall riskiness is, although in practice it doesn't seem to have worked out that way.

If, of course, we go back into a model where we do think the banks should be more specialised and should be smaller then, of course, the systemic risks I think won't disappear as a result of that.

And that brings us back, of course, to a much greater emphasis on the need for this macro prudential regulation. Because if the banks aren't going to be able to handle this within their boundaries, then the Bank of England or some kind of regulator has a much greater responsibility to make sure that the smaller, and by implication therefore less powerful, players aren't actually ploughing their own particular furrow oblivious to wider dangers.

Now going back to banks that are too big to fail, it may be that size isn't important or it may be that what people are really saying is that there's a particular function that can't be allowed to fail.

So we all see that there's a certain way in which the banking system as a whole produces a public utility and it is the kind of integrity of that public utility that we can't really risk. There has to be a kind of freely functioning payment mechanism, a kind of store of value. Companies and individuals are going to have to have resources that they can meet their bills with on time.

And, of course, it was the prospect of all that `[[gumming 0:28:03]]` up that was so frightening back in September, October last year.

Now whether if you've actually got regulation of the system, whether size of the players in it is important is, I think, as Jonathan mentioned the word monopoly, I think what we've got is a problem of monopoly power of a small number of institutions dominating this utility.

And I suppose that might, if you think about other models, take you back into the ideas, the models that were batted around in privatisation; areas like gas and electricity and telecoms and railways.

Is it the case that we should actually ensure that that kind of basic utility function either stays in public hands or under high regulated control? And then we just let individual private sector players, as it were, use the network, as they can use the gas pipeline and they can use the electricity grid, without too much worry about what they're doing.

Or do we actually have to keep the whole thing fairly heavily determined in order to stop crises occurring?

The evidence from privatisation is rather mixed. If you think about some of those kind of industries, telecommunications seems to be quite a success of actually privatising and letting a lot of competition go and things like that.

At the other extreme, railways would not, I think, be considered a great success where again we have a network company which is supposed to be protecting the public utility and then operating companies which could be considered to be much more competitive and they could be free to succeed or fail. Well, we see that that doesn't work terribly well there.

But I think it's probably those kind of industrial economics issues that might actually need some kind of looking at as well as the further financial one.

Linda I'd agree with both of what you've said. And I think this crisis showed how important the banking sector is and they hold our deposits, they run our payments; they're essentially the lifeblood of the economy. They will not be allowed to fail. And that inherent moral hazard makes them more risky and I think if that was the case, and I think it is the case, I think there is a lot to be said for having either a new type of model to run the system or, at the very least, what's being talked about now, which is to make them self insure.

If they're too big to fail and they need to be bailed out, then they need to pay into a bail-out fund; a tax on their - whether it's in the form of capital requirements or some other way of actually making them pay for the risk they clearly will transfer on to the taxpayer.

It's very similar, actually, to a deposit insurance system which is funded by the banks so that if one of them fails, they draw on it and our deposits are protected.

So I think there have been a lot of complaints in this crisis about banking being favoured and I think what it's ultimately come to is that banking is special in a way because of the function of money in an economy. In which case I think they do need to be regulated differently and I would like to see them take on a lot more of the risk of failure.

Jonathan Yes, that's right. But it's important to remember that the banks have had this special place, particularly in Britain. There's been a longstanding problem ever since the industrialisation really in Britain of the City of London, of the financial sector, being so dominant to an extent that there never was the case in France or Germany or Sweden or other countries.

And I think this is just the latest example of that problem. It's being time and again that there's been a need for the British economy to diversify away from the financial sector towards manufacturing and non-financial services for decades. And problems of the financial sector, the City of London, not properly funding particularly small and medium-sized enterprises for understandable reasons because they had bigger fish to fry. They basically developed as a global operation.

So it's well to remember it's not just a problem with banking in the abstract. It's a problem that the UK particularly suffers from.

Linda The other big economic policy area which has been heavily debated is this use of government spending in a recession. So the debate as to whether or not we ought to deficit spend has come to the fore with big differences of opinion again between the Americans and the Brits on one side and the French and the Germans on the other.

Has this crisis led us to think differently about the Keynesian notions of deficit spending? Are we going to look at the fiscal policy differently in the future or should we?

Jonathan Well certainly the name Keynes is coming back into the newspapers but actually I'd say that it hasn't gone nearly far enough. I think what is really needed is for people to go back and reread Keynes' 'General Theory of Employment, Interest and Money' published in 1936 at the depths of that 1930s recession to see what he was actually arguing.

It was actually very radical, very perceptive, I think. It gives a very good explanation as to what's happening to the world economy at the moment. But the problem was that he didn't think these economic relations could be quantified, mathematically modelled, discretely. And so it was very unsatisfactory for the economics profession, particularly the academics who wanted to model it in their textbooks.

So the textbook version of Keynesism that I and other people were taught in the '60s and '70s was actually quite different from Keynes. And the fundamental point I'd say is as follows.

That what Keynes argued in the 1930s to try and explain what was going on and why there was a global recession and why there was mass unemployment was that what really drove the system

was effective demand and the part of regular demand which really fluctuated was investment. So it was really investment which drove the system. That determined how much demand there was. That determined how much the level of goods and services provided to meet that demand. That determined how many people were employed and therefore whether you had mass unemployment or not.

And what's fascinating is that description as to actually why there was mass unemployment in the 1930s when economists up to then had said "You couldn't have mass unemployment", that description actually didn't mention the labour market. It was all about investment creating demand, creating production of goods and services to meet that demand.

And the problem, as I was just saying for the attempt to put that into textbook fashion, is the real driver for our investment levels were expectations as to what the level of demand would be in six months or two years when the goods would come on stream from the new factories you were planning on investing in and so on. Expectations of what Keynes described as animal spirits and so on, which is obviously very unquantifiable.

And Keynes said explicitly that, that he thought it really was unquantifiable. It wasn't just that like flipping a coin you didn't know whether it would come up heads or tails, it was actually you didn't know what the probabilities were of different states of the world and outbreaks of wars and so on; literally unknowable things.

So I would say it's good that people have started mentioning the Keynes again. But actually the real lesson of Keynes goes far beyond the point that government can serve a useful role by stepping in to boost demand when there's a collapse. It reminds us that the real driver is actually that level of aggregate demand and crucially investment and therefore expectations as to what will happen in the future, rather than the textbook model that is all determined in the labour market by relative prices and wages and so on and everything flows from that, which is completely the wrong way round of looking at it.

Martin Yes. I think probably one of the big lessons of the last couple of years is, as it were, the return to prominence of inevitable uncertainty which, I think, is what Jonathan was saying, is a fairly big part of the Keynesian view of investment.

Now, it's understandable that for modelling purposes one likes to feel that one's on top of uncertainty and there are various theoretical devices one can use to make it look as though you're on top of uncertainty. As there are lots of practical financial devices obviously that the financial markets have developed to try and deal with uncertainty: insurance of various kinds and derivatives and those kind of things.

But in the end, I think, what the recent experience has shown is that you can't rid of it completely and, indeed, if you do think so you're probably going to be bitten by a very nasty surprise like the last year or two has shown.

So yes, I think that in that sense there's a big lesson here that one cannot just rely on some kind of perfect system to handle all these kind of issues and there will be the need for judgement and discretion to take us over some fairly rocky activity.

I think it's interesting also, I think, if you look back on people's descriptions of the last, say, couple of decades which might have, in one sense, been thought of as a very benign period.

Other people writing about exactly the same period will say "If you look at the statistics, this, of course, was not a very benign period." One had enormous international crises appearing regularly at five, six, seven year intervals. And it really is quite surprising that people develop themselves into a mindset that they'd actually sussed the kind of problem out and had actually worked out how to regulate the global economy. And at each international crisis quite lucky to contain them at the time. And eventually the crises got bigger and bigger and we've just run through a very, very big one indeed.

And the prospects for the future, clearly we've got no reasonable ground for believing this is not going to happen again.

Linda No, I think that's right. I think one thing which is obvious is some type of bubble seems to be fairly endemic. And if you attribute the bubbles to economies overheating, the peak of a cycle, then, in a sense, the business cycle just runs. The question is what drives it. Is it Keynesian deficient demand, as Jonathan has outlined? Is that now more in vogue than, say, real business cycle theory, which is exogenous supply side technological shocks?

So I think unfortunately when the British Prime Minister, when he was Chancellor, claimed to have ended boom and bust, that was just very unfortunate because I think the business cycle runs but it just runs in different ways with different parameters.

Another way of saying it is that every financial crisis is actually different and every model we tend to devise to regulate a crisis was obviously based on the determinants of the last crisis. So we've got this crisis now. There was the dot com bubble back in 2000, 2001, which was preceded by the collapse of long-term capital management, a hedge fund, in the US run by no less than Nobel laureates in economics. That, of course, came on the aftermath of the Asian financial crisis which had spread from East Asia to Turkey and Russia and Argentina and Brazil. And that was preceded by the peso crisis in Mexico in 1994 which was itself preceded by the third generation currency crisis of the Asian financial crisis and the second generation crisis was the exchange rate mechanism in Europe which failed in 1992 which itself was preceded by the S&L loan scandal in the United States which was itself preceded by the Latin American currency first generation crisis in '81, '82.

So perhaps a lesson that we've learned is that we don't really understand what drives business cycles.

But I just want to bring it back for a moment to the fiscal debate that's being had because I think this one has become quite a dividing line for different policy makers around the world, which is should the government borrow to spend during a recession?

Martin Well, I think the answer to that is yes. The argument against borrowing, the argument against deficit spending, is that in an ideal world deficit spending ought to be counterproductive because you have things like Ricardian equivalence. Far-sighted transactors will see that deficits have to be repaid at some time. So we would not necessarily feel we're any better off now because we know we're going to have to pay it back later.

But, of course, Ricardian equivalence relies on, essentially, a system of perfect capital markets. Now the thing we quite obviously don't have at the moment is perfect capital markets. So in a situation where you're being disrupted by the failure of capital markets it's not terribly surprising, I think, to see that deficit financing will have positive effects. And I think that that will come to be fairly clearly accepted in a few years time.

The obvious danger of deficit financing, particularly at the levels governments have had to do it, is whether this is actually going to produce debt levels that are in some sense unsustainable and are themselves a drag on confidence, which leads you back into the Keynesian investment determination kind of activity.

That's clearly, I think, the difficult issue at the moment and I don't think one can easily say whether the levels of debt currently projected are going to take us into that kind of territory or not.

One can say at the moment the UK and the US governments have not had great difficulty in selling the debt that they are selling at the moment but that only takes you so far.

The big problem here is whether maybe at some time in the future the markets, for one reason or another, and we can't really predict why - it may be nothing to do with the UK economy - but for some reason their particular appetite for holding all this British government debt disappears. And

then, of course, the British government will be in the classic indebted position of somebody who was encouraged by financial institutions to take on all this debt. And they said at the time that was fine by them but at a later stage you find that perhaps it's not fine by them after all.

And I just don't know the answer to that at the moment.

Looking historically one can see that actually the levels of debt, even in the UK as projected, are not historically without precedent. They're clearly a lot higher than the aspirations we have had in the last 20 years but the UK and other countries have had higher levels of debt without any great disasters.

Japan, for instance, has much, much higher proportion of debt to its GDP even than the projections in the UK and the US.

Linda They're 200% of GDP by last count.

Jonathan Yes, I'd agree with that. The basic economic point it's important to emphasise is that, which is one of the points Keynes was making in the 1930s' recession, is if governments try and cut their spending during the recession, the danger is that can actually make the recession worse.

Obviously that depresses demand, not just because the government's spending less but then people have expectations that the recession's going to get worse so they decide to save a bit more and so they spend less and so they demand less and so more factories and shops close and the recession deepens.

And the result of that is, ironically, the government deficit goes up rather than down and that's the basic point. So even if we're all agreed that the aim has to be to reduce the government deficit, the question is how to do it. And cutting government spending during recession won't necessarily do it. It might actually exacerbate the recession and actually increase the deficit the government has.

So that's the fundamental point to bear in mind. I think then the question is well, what should the government be spending the money on during the recession? Should it be for bonuses for the bankers who are running the nationalised banks? Or should it be investment in the productive infrastructure to try to develop new green technologies and so on.

And obviously the way I've phrased the choice I favour the latter. Not only because it's good for the economy, but crucially it's important that the government develops their productive infrastructure and new technologies which will then crowd in investment from private companies who see new markets developing, new areas for potential investment.

And that's the crucial thing in terms of developing sustainable growth out of a recession which, in turn will bring in increased tax revenues and, of course, once the economy is recovering, then will allow government to cut spending and, again, important to cut spending on things which won't jeopardise the recession but things which are, in the UK maybe the ID cards or Trident nuclear missiles or whatever rather than cutting things like the railways or investments in green technologies and so on.

So to answer your question about Keynesian `[[deficit financing 0:47:48]]` I think the basic point is yes, cutting government spending during a recession might make matters worse. The key issue is to make sure that the government spending is invested in productive areas.

Linda It reminds me of a saying that politicians banter around, which is whatever your opponent wants to do is called spending. What you want to do is investment. I think if you really do invest with payoffs in the future, there is this idea of crowding in where public spending on infrastructure and other things can make private spending more efficient. If you build a high fibre optic network any private firm which locates there and uses it obviously will be more incentivised to invest and get more return out of their investment. Whereas the usual expectation from high levels of government indebtedness is with a fixed stock of savings. You will have an increase in interest rates which then crowds out private investment.

So it is, I think, in a sense the crowding in versus the crowding out argument.

Macro economics has always been a very interesting subject because the models and the theories evolve with changes in the way that economies are actually run. And I think this is a particularly fascinating time because this particular crisis has raised a lot of questions about the fundamental ways in which we run monetary policy, fiscal policy, regulate financial markets and contend with a globalized economy which has its benefits but also raises a different slew of challenges.

And this summer will be quite telling as we hear more and more about policy pronouncements, about how we're going to reform these models and theories. And I hope that academics will also chip in to help formulate new models and theories going forward.

Jonathan Yes. And I hope everyone will put pressure on governments and other authorities to actually adopt them. I think the one big danger now is as soon as the economy seems to be recovering, those who have a vested interest in the previous set up will say, "Well, we managed to pull out of this. Everything's basically all right" and return to business as normal, risking the same sort of horrors in 10 or 15 years' time.

So I think it is important that the necessary reforms are driven through both globally and in individual countries.

Martin Yes. I think politicians' and practitioners' interests in theory are obviously rather driven by the needs of the moment and, as Jonathan says, if it looks as though for practical purposes the crisis stage is over, then I fear one will find that the practitioners lose a lot of interest in the theoretical underpinnings of what we've been going through.

I think the important thing for the future is to consider theoretically whether our stance with regard to regulation and policy is one in which our background theory of the economy is one in which the economy is relatively stable and just needs a little nudging every now and again to keep it on the right path. Or whether the theoretical understanding of the economy really points to rather more significant flaws in the economy which actually do need some rather serious and long-term interventions, some of which we've been discussing here.

And I think from the point of view of theorists I think that that's the kind of thing that they should be looking for in the next few years.

Linda Well, there are some thoughts to chew over over the summer. Thank you very much for listening to our series for this academic year. And we hope you'll come back for the next series starting in the autumn.

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