

Tacitus Lecture

Many thanks for your invitation to give this lecture. The level of interest is flattering. I see that in over 20 previous lectures you haven't previously had anyone who could be described as a practising politician, except for Lord Owen who had left politics a decade before, and Lord Digby Jones who hadn't then entered it. I am not sure that my advancement to this lectern reflects a rise in the esteem in which the political classes are regarded; more likely a decline in the relative standing of others, notably the bankers.

I am particularly honoured to follow in the footsteps of Sir Mark Moody Stuart who was, for a while, Chairman of the Managing Directors while I was at Shell and who constantly sought to reconcile high standards of business performance with high ethical standards, and succeeded in both. Sadly, the dreadful, sordid, swamp which currently characterises much of the financial sector owes much to people – I think, a relatively small number – whose business acumen, by contrast, was as deficient as their ethics.

I will make reference to the current national policy debate in which I am a participant but I envisage this lecture as doing more than giving a commentary on today's events but reflecting on the wider implications of the crisis particularly as

it affects your primary concern which is an open trading system. At the time when you were establishing the Guild of World Traders a quarter of a century ago, I had just published a book on trade and trade policy called 'Protectionism and Industrial Decline'. Like you, I believed and continue to believe in a free and open trading system but I was worried about threats to its future. In the event the threat to world trade never materialised.

Then we had several decades in which the values which your livery company espoused, and mine, were triumphant. Trade and foreign investment boomed world wide. For the first time in three centuries, the giant economies of China and India started to move forward pulled in part by trade and the world economy, and lifting hundreds of millions out of extreme poverty until they were, in turn, pulling the world economy forward. We seemed to have reached an ideal world in which living standards were rising in most parts of the world and the virtues of an open, free trading environment were understood and increasingly applied.

But, there has throughout been a worrying instability which I tried to capture in a book publicized ten years ago under the rather pretentious title of 'Globalisation and Global Governance.' The essay was a strong defence of globalisation but it expressed concern about the lack of strong international rules and institutions. These expressions of concern have been vindicated. In the

banking sector, in particular, there has been a vast growth of cross border activity without an institutional and regulatory infrastructure strong enough to support a global collapse of confidence and systemic failure. I believe that the lack of satisfactory rules and governance is a key factor in the crisis.

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But let me reflect a little on the nature of the current crisis: how we got where we are and what is actually happening. I am sometimes given credit for getting some things right but if I have any unique understanding it is that of being the one eyed man in the kingdom of the blind. I confess to being bewildered by the speed and the severity of the collapse which is taking place and its extraordinary reach. With every day that passes there are reports of bigger and bigger losses in the financial sector, increasingly gloomy forecasts of growth- in fact, declining output in many countries. I keep hearing that there are little pockets of the world economy which seemed to have escaped lightly- Norway, perhaps Canada- and I would imagine, though I do not know, that outside the major financial and manufacturing centres, in the Asian giants – China, India – life goes on as much as before. But I may be wrong.

What is clear to me is that the UK political world which I inhabit is not a source of enlightenment. The weekly party political pantomime goes along the

following lines, 'it's all your fault, Gordon'; 'no it isn't, it's a global problem', 'yes, it is', 'no, it isn't'. The truth is that there are domestic and international failures. Domestically, a bubble in house prices, and associated mortgage borrowing was allowed to grow to dangerous levels such that UK household debt and house prices in relation to earnings were unprecedented and, virtually, the highest in the developed world. There are legitimate criticisms of the lenders (and indeed some borrowers), the regulators, the Central Bank and the government which swept criticism aside, from me and others. The bubble was bound to burst.

But in itself, this was a manageable problem. What is making the problem unmanageable is the simultaneous collapse of the international banking system and deep global recession. I characterise this failure as akin to the collapse of a giant financial pyramid selling scheme- though in this case there was no criminal intent, except in the margins where the likes of Madoff lived. The causes are obviously complex: a mixture of over complexity, greed, euphoria and ineffectual regulation. There was, too, a deeper problem: the imbalances between the economies which saved too much – like China and Japan - and those like the US and UK- which saved too little and the inability of private financial institutions to manage the compensating capital flows in a stable manner.

What also matters for those of us in the room is the wider impact of this financial collapse on trade and the real economy. Trade has been directly affected by the drying up of trade credit and indirectly, by the way in which the impact of a sharp reduction in consumer spending and business investment has been transmitted to countries particularly dependent on exports. It is very striking that, the most brutal cuts in output recorded in the last few months have been in those areas most dependent upon manufacturing exports- coastal China, Korea, Taiwan, Japan and Singapore. That may change, however, as the global recession spreads. Indeed much of the current anxiety centres on Eastern European countries which played by competitive rules and invited in foreign banks which are now withdrawing lines of credit.

From a parochial UK standpoint, this country does look exceptionally vulnerable. Britain has three of the world's largest banks, each with a balance sheet bigger than the UK economy, and that excludes Lloyds/ HBOS. As bank losses mount, the risk to the taxpayer and bank customers mounts and could prove to be of mind boggling proportions. It is also a problem that the UK has a massive budget deficit- probably 10% of GDP this financial year- much of it due to structural factors, such as the loss of income from the City and housing- which greatly reduces freedom of manoeuvre.

It is not possible to predict what will emerge from this crisis. I always recall the advice given to me when I was Shell's Chief Economist, in the form of a picture on my wall in the form of an Arabic saying which, translated, meant "those who claim to be able to predict the future are lying even if by chance they are later proven right". So when government ministers claim to see green shoots of recovery and other Ministers say this is the worst crisis for 100 years: beware, they do not know what they are talking about. What we can say based on historical experience is that banking crises- like property and commodity boom and bust cycles- follow a roughly predictable pattern. The failure to recognise and understand the cyclical nature of these markets lay behind much of the false optimism, the hubris, which preceded and aggravated the crisis, not least in Britain. Experience suggests that financial crises follow a regular series of phases- from optimism, to euphoria, to panic, to denial, to despair, to recovery and we currently seem to be in the despair phase. Typically, it takes around a decade to recover fully: less when there is a smartly organised exit as in Scandinavia, more when there is prolonged denial as in Japan.

It is possible to derive some comfort from the fact that the main countries directly affected by the crisis have reacted quickly and aggressively to rescue and recapitalise banks, to provide a fiscal stimulus to demand and to relax monetary policy. Controversial but necessary policies like quantitative easing – the creation of credit – are on the way. It is also comforting that, so far, there has

been a broadly consensual approach such that the crude nationalism of the 1930s has been contained. Despite finger pointing at the UK, Germany has produced a fiscal response, actually bigger than ours. And despite China-US tensions at a political level, the Chinese have been cooperative in providing a stimulus and making large purchases of US Treasuries.

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The key issue for a world economy which is so globalised, so dependent upon trade and investment flows, is whether that cooperation can be maintained under the extreme pressures which now exist.

Despite the reassuring point that I have just made, it is clear that in the current environment of anxiety, and sometimes panic, governments are falling back on national responses to what are often global problems.

Let us take banking. Last autumn Ireland tried to prevent a panic by depositors in Irish banks by offering a blanket, unlimited, guarantee to protect them. Other countries followed suit to stop a hemorrhage of accounts. Major EU countries like Germany offered qualified guarantees and the UK government made more explicit its implicit guarantees. Fortunately, the narrow, nationalistic,

beggar-my-neighbour approach was contained but it was shown how quickly such practices could spread even within the UK.

Then, as banks have tried to deleverage, reducing access to credit, governments of most countries like the UK which are underwriting the losses of big global banks not unreasonably expect banks to maintain lending to their domestic firms. I have been heard to urge 'lending to solvent British companies' though I know quite well that the logical implication is a reduction in the banks' overseas lending since the banks are de-leveraging overall. It is a kind of protectionism but impossible in practice to resist since global banks are not being underwritten by the globe but by British taxpayers.

National responses to the crisis also run the risk of generating various forms of 'unfair competition'. State supported banks are likely to offer more credit on better terms than those private banks which are trying to contract to build up their reserves against future losses. There are tricky issues of what constitutes unfair predatory pricing in this unusual (albeit temporary) environment. But they cannot be avoided since the leading banks in the UK, the USA and elsewhere will be nationalised in name or in fact for some years to come.

There is enormous pressure more generally for state aid to what are regarded as 'strategic' industries, among which the vehicle and steel industries

are particularly vulnerable. There is rarely a sound reason for these sectoral interventions but the EU competition authorities, and the WTO, are struggling to enforce competition rules, as they must.

One aspect of policy which is national and where there are few international rules is migration. We are already seeing attempts, even within a free labour market like the EU, to create national jobs for national workers and EU controls on migration from outside the EU, even on essential staff, are being tightened. I know as a constituency MP that the dead hand of the Immigration and Nationality Department and the new quota system will cause much inefficiency and injustice.

We have so far not had the crude trade protectionism of the 1930s, though the 'Buy American' provisions in the US fiscal stimulus package come close to it.

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That is what is happening. There is already serious backsliding in government commitments to an open trading environment. Yet, we are at the early stages of a crisis which may yet go much deeper and longer. The fabric of international rules and disciplines will be stretched, perhaps to breaking point. There are some obvious danger points which haven't yet become manifest. The

US-China-EU triangle of mutual interests is fragile but has so far held together. It is not entirely a joke to say that the Chinese Communist Party is helping to keep Western capitalism afloat. But trigger-happy US or EU trade policy protectionists or an aggressive Chinese approach to export promotion through devaluation could unleash a tit-for-tat dispute with very damaging consequences. Then, there are countries which have tentatively dipped their toes in the bath of liberalisation and are being scalded, perhaps tempted to withdraw altogether. India and Brazil are examples. There are plenty of Indians – on the political ‘right’ and ‘left’ – who are relieved that they kept their banks under state ownership and feel they have already opened up too far.

Within deeper integration arrangements like the EU and NAFTA there will also be strains. If pressures build up, who will rescue Italy or Poland or Spain? The Euro zone’s resilience may have been underestimated but it will be severely tested in the next year or so. The question originally put by Jacques Delors - what happens to the EU bike when it is no longer moving forward - will have to be confronted. There is some risk – though currently low – that the liberalising achievements of the EU could unravel. This is perhaps even more true of NAFTA where the Mexican economy is fragile and US protectionist instincts are strong.

These trends – towards a reversal of globalisation and a reversion to nationalistic behaviour – are not inevitable and many governments including ours

have outward looking instincts or, at the very least, an understanding that if they do not hang together they will hang separately.

The forthcoming G20 meeting in London is crucial to stopping the rot. There are some imperatives. One is that the multilateral bodies, notably the IMF, and possibly regional versions of the IMF, as in the EU, should be sufficiently well resourced to cope with the liquidity requirements of the substantial numbers of countries facing a crisis and without the onerous conditionality which has driven Asian countries to excessive reserve accumulation in the past. There is a case for a large, urgent, SDR issue for this purpose. A second is that, where possible, further monetary easing or fiscal stimulus is coordinated among the major economies – as was the response last autumn. A common approach has the effect of providing political cover for controversial policy and reducing the risk of destabilising attacks on exchange rates and worries about sovereign default. It is also mutually reinforcing and should build in the principle of open markets (not ‘Buy American’ and its equivalents). Third, and crucially, key decisions have to reflect the new reality that economic power increasingly lies in the East. Alongside the US and the EU, the Chinese, in particular, have often been happy to take a low profile and avoid responsibility while European countries cling to voting rights in international institutions and seats at the top table which are unrealistic. Fourth, the system of financial regulation through the BIS, the EU and voluntary groups like IOSCO has to be reformed. The banks’ rules on capital

adequacy have not broken down but their rigidity – and pro cyclical effects – have contributed to the problems. And lastly, the sad whimper with which the Doha Round expired should not be regarded as the last word. There is little appetite at present for a new round of trade liberalisation but unless the recalcitrants who destroyed the talks last year are dragged back to the negotiating table there is a danger of the economic bloodletting which characterised the 1930s.

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I want, in conclusion, to turn back to the UK and the City. When the UK economy was booming, and the world economy was booming, the City was booming. The causality went both ways. There was quite a lot of mutual back-scratching. UK politicians sang the praises of the City and the City contributed tax revenues to the state (albeit with quite a lot of leakage into tax avoidance). The ideology of free trade which animated the city was consistent with an outward looking approach to trade and foreign investment, and even migration, which the British political classes have supported (migration is less consensual of course).

That mutually supporting construct is now in danger of falling apart. The big global banks which were once valued for being the biggest in the world and

for bringing business to London (or Edinburgh) are now seen as giant Trojan Horses putting the very survival of the UK economy at risk. It is increasingly being said that not only are the global banks, 'too big to let fail'; but also 'too big to save'. I don't believe that the problems are that extreme but they are certainly very difficult. Then, the easy going approach to tax – the blind eye turned to non-doms and to clever corporate tax avoidance – is likely to be sharply reversed as the public finances deteriorate. The new national mood of austerity jars badly with the bonus culture of the City and there is mounting resentment. When the head of the FSA attacks the politicians not for regulating too much but for regulating too little, as he did yesterday in Parliament, you can be sure there is a fundamentally different mood.

I do not think it is realistic to believe that one can return to where we were before the crisis (and that is true, too, in the financial centres like New York and Frankfurt or Zurich). Whatever happens, the UK financial services sector will contract sharply in absolute and relative terms. I think there are two plausible scenarios for the future: one disastrous for the City; one more positive. The disastrous scenario is if the current mood of anger and recrimination continues, fed by continued reports of bank bonuses and inflated salaries, I can see the banking community being treated the way in which Mrs. Thatcher treated the miners, effectively destroying their industry. Such economic vandalism could be very damaging for all of us. The case for the City's continuing importance in

international trade has to be made; and I for one am happy to make it. Most of the people who work in the City do not work in the leading banks and they contribute considerable wealth in uncontroversial ways.

A better scenario involves the acceptance of reform. One key element will have to be the splitting of low risk, safe, domestic high street banking from high risk activity, much of it in investment banking (though I realise that risk and structure do not perfectly cumulate in this way). The former would be treated, in effect, as a regulated utility. The latter would be free to operate in a competitive international market without state protection, obviously subject to basic regulatory requirements of transparency and capital adequacy where systemic risk is involved. I simply do not understand why Gordon Brown persists in resisting reforms of this kind and the bankers who encourage him do their industry no favours. It is simply not sustainable to have a domestic banking system which is an add-on to global hedge funds.

My colleagues and I set out some proposals in a New Deal for the City published last autumn. The philosophy was essentially liberal, but argued that some of the old practices would have to change radically, in areas such as remuneration.

The free trading traditions of your company, and the City, must be maintained in the interests of the national economy but what this crisis has taught us already is that the City cannot operate in a way which is divorced from the wider UK economy and society.