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Examination of Witness

Witness: MR WILLEM BUITER, Chief Economist, European Bank for Reconstruction and Development, examined.

Chairman: It is a great pleasure to see you and you know the line of questioning. Lord Sheldon is going to start us off.

Q379 ***Lord Sheldon:*** I am asking about what you consider to be the main strengths of our economy at the present time. At different stages in the economic cycle, the relationship between monetary and fiscal policy may need to change. What changes in the policy framework do you think are needed to take account of this?
Mr Buiter: The British economy is in the favourable and unusual position of having avoided any significant cyclical downturn since before I joined the MPC in 1997. It is quite a remarkable stability over a number of years, especially given the travails of the neighbours, both on the continent and in the United States. There has been greater stability here. Part of that—maybe most of it—is luck. That is always a major factor in economic management. Part of it is also the fact that the framework for macro-economic management, both monetary and fiscal policy in its macro-economic aspects, is fundamentally sound in this country and I think superior to that in the other main industrial countries. In the US, nobody makes fiscal policy. It just emerges out of the tripartite deadlock of the House, the Senate and the White House. There is no design. If it is cyclically appropriate, as tax cuts were a year ago, it is entirely by accident and not by design. In Japan, there has been until recently, until the departure of the old governor of the Bank of Japan, a state of undeclared war between the Ministry of Finance and the Bank of Japan. There is the Central Bank Governor who in the midst of persistent deflation kept speaking of significant fears about the risk of hyper-inflation, which was something that always amazed observers like myself. On the continent, especially in the eurozone, we see that the countries with large national economies are structurally less flexible than the United Kingdom. On top of that, the whole monetary management system and the interaction of monetary and fiscal policy in the eurozone had to be learned from scratch. The fact that it was not the most elegant exercise since the invention of central banking is not to be held against it because this really is a unique, incredibly difficult experiment, making 12 national central banks fuse into one central bank in very difficult circumstances. Whatever the reasons, the rest of the world did worse than the UK. The fiscal and monetary framework, while not perfect, is the best on offer.

Q380 ***Lord Vinson:*** Welcome back. Our short term interest rates are roughly double the eurozone short term interest rates and roughly double those of industrial countries with a comparable rate of inflation. Does this tell you anything about our monetary management? Does it in turn make any closer association with becoming part of the eurozone rather difficult?
Mr Buiter: It is an excellent question, which is what I always say when I cannot think of the answer. It is surprising that we now see 4 per cent Repo rates here. It is 2 per cent in euroland and 1 per cent in the United States. This vast gap diminishes completely and disappears when you look at longer maturities. The anomaly is just at the short end. Partly it is because the monetary authorities here believe that there is an inflation risk that needs to be addressed now. If that were not so, the last two base rate increases would not have happened from 3.5 per cent to four as they are now. Even if they had stayed at 3.5 per cent, that would have been significantly higher than the numbers in euroland and much higher than the numbers in the United States. In the US, the explanation is that monetary policy in the US has been very loose, probably too loose, for quite a while now. I do not know what drives the authorities there but it is clearly at an unsustainably low level. You cannot have 1 per cent nominal interest rates going into a bout of healthy growth. These rates have to go up and they will go up. The gap between the continent and the UK is more difficult to explain at the short end. Part of it is different perceptions of inflation risks and part of it is inexplicable. There may be differences in the transmission mechanism. People always talk about the disproportionate

importance of short term rates in macro-economic management in the UK through mortgages, bank lending and all these things, but even then I do not think that explains the whole puzzle. There remains a paradox or a puzzle. It has been there for a long time now and I cannot account for all of it.

Q381 ***Lord Sheldon:*** Our economic stability is arguably greater than we have had for a century or even possibly more and there may well be a hiccup shortly coming, but do you see the return to long term stability after that if this happens?
Mr Buiter: I have no doubt that the current framework if adhered to, and if the markets at home and abroad believe that the framework will be adhered to, is conducive to sustained macro-economic stability. There will be fluctuations. Capitalism is a cyclical system. It is never going to be smooth growth. We will probably see greater fluctuations and greater departures of the inflation rate from the target than we have seen in recent years, but the return to the dismal management of the '70s, '80s and '90s is completely unnecessary and should not happen.

Q382 ***Chairman:*** You were a founder member of the MPC and therefore you know what its remit is. This Committee's understanding is that it would raise interest rates precisely as you say because you would do it when you were forecasting inflationary pressures. The difficulty I am having is I cannot see these inflationary pressures. Can you?
Mr Buiter: To really answer that question satisfactorily, I would need to have been briefed the way I was on the Monetary Policy Committee and to have given it serious consideration. I am a monetary tourist at the moment, not a pro. It is clear that inflationary pressures would be on the horizon if you take the old index, RPIX, running at 2.9 or 3 per cent or thereabouts. Of course, this change to the new index, the CPI, which used to be the hiccup. It was much better as the hiccup, I think. With the CPI, the current inflation rate is 1.3 per cent, well below the new target of 2 per cent per annum, so there must be a pretty confident anticipation of an increase in inflation over the horizon over which the Monetary Policy Committee believes it can influence it for these recent decisions to make sense. I am looking forward to reading the next inflation report and the explanation and motivation of the decisions. One should never look just at current inflation or in the back mirror at past inflation. You always target future inflation because that is all you can influence. I expect that you will see a satisfactory explanation but clearly there is something *prima facie* to be explained.

Q383 ***Lord Wakeham:*** You have hinted at the answer to the question about the switch from RPIX to CPI. We have had different interpretations of it as to whether it is a mere formality or whether it is very significant. You hinted that there might well be some difficulties with the Bank of England in settling interest rates in the future. I wonder if you could enlarge on your views and whether you think there will be difficulties.
Mr Buiter: The switch is clearly significant. It is not a formality. It is significant politically because it sets Britain up for easier approaches to euro adoption and membership in EMU in due course. At a technical level, with the gap between the old and the new target currently at 1.6 per cent and with the target rate only having been lowered by half a per cent, the economy, if we take the current inflation rate as a gauge for these past inflationary pressures, would have shifted from being in an overheating situation to an underheating situation. There is a difficult and confusing communication exercise that the Bank has to engage in to convey to the market what the consequences of this change in target and yardstick are. They have also to figure out—and this is probably the hardest part—whether the transmission mechanism of CPI inflation might be different, at least over a reasonably short horizon of up to a couple of years, from the mechanism for RPIX inflation. I am not saying the change should not have been made. On balance, I support it but it definitely makes the job of the Bank a lot harder for quite a while until this beds down and until they learn the new transmission mechanism.

Q384 ***Lord Wakeham:*** Do you think the recent changes in interest rates have any reflection upon this change in the index, or potential change?
Mr Buiter: The recent changes are harder to explain in light of the new target; in light of the old target they would be easier to explain.

Q385 ***Lord Barnett:*** When you were a member of the MPC, you tended to differ more often than not with your colleagues in not wanting to increase interest rates. You talk about this gap between the CPI and RPIX which at the moment is wide, but the reason we have been given frequently is that it will change over the next year or so. On the other hand, the MPC have to chose an interest rate which will enable them to be able to get within their inflation objectives, which is their main remit, over a two-year period. Would you have voted for an increase today?
Mr Buiter: The MPC does not have a two-year target. The target is to meet the inflation objective, which is now the CPI objective, from this day forward until the end of the world. The two-year horizon is just an administrative convention because that is when the paper ran out. There is no behavioural or other

significance to it. It is not true with any degree of confidence that monetary policy is most effective at a two-year horizon. It may be partly because there is this old saying of Milton Friedman in the subconscious of many monetary economists that monetary policy does have its main impact on prices after two years. It has never been tested and confirmed in the UK, but never mind. The two-year horizon does not matter. What I would have done I cannot say because I am not privy to the information that the Committee have and no tourist should second guess the professionals.

Q386 ***Lord Barnett:*** You do not want to answer my question?
Mr Buiter: I do not want to answer on what I would have done because I honestly do not know.

Q387 ***Lord Skidelsky:*** You talked in your earlier remark about the Finance Ministry and Bank of Japan being locked in a great struggle and that leads me onto the question of how in your view should fiscal policy support monetary policy. It should support it, presumably. How best should it support it? Is it a good formulation?
Mr Buiter: Monetary policy should be used to target inflation over the medium term. Fiscal policy should be designed to finance government expenditure in a sustainable way, hopefully leaning against the wind with the automatic stabilisers in a way that minimises unnecessary economic fluctuations. The rules that were adopted are not inconsistent with that. There is no active fiscal management in the sense of discretionary changes in tax rates or spending programmes in response to changes in unemployment or the output gap. Active fiscal policy is only appropriate when the house is really on fire. If you talk of the Great Depression, clearly you cut taxes massively or spend on public works programmes, but for normal business fluctuations all you should do is let automatic stabilisers operate and make sure that the build up of government debt does not threaten government solvency and sustainability. The current programme rules are consistent with that although there are many other rules that would also be consistent with this objective. In particular, the government has the Golden Rule on a cyclically adjusted basis and the 40 per cent net debt rule. There is nothing in particular to recommend them but they are also obviously not destabilising. Having put them in place, we might as well see how they work for a bit longer.

Q388 ***Lord Skidelsky:*** An expression much in use now—Ed Balls used it in a recent speech which has been circulated to us—is that of constrained discretion to differentiate it both from the very rigid rules of the stability and growth pact and from the wild Keynesianism that used to be practised. Can that phrase be made operational? Does it have a substantive meaning?
Mr Buiter: No. It is a sound bite.

Q389 ***Lord Skidelsky:*** Could you elaborate on that? Why is it a sound bite?
Mr Buiter: Constrained discretion is a phrase that sounds good but does not mean anything. What does it mean operationally? "Discretion" means that you act opportunistically. It is therefore, inconsistent with "constrained". The real contrast is between acting with commitment or acting opportunistically, and between acting rigidly and responding flexibly to news. You want to act with commitment and respond flexibly. If that is what is meant by constrained discretion, I am all in favour of it, but in that case I would call it what I just called it: responding to unexpected developments, responding to news, through a rule that is clearly understood by the private sector. Otherwise, it does not mean anything.

Q390 ***Lord Skidelsky:*** If you do it according to a rule, it is no longer discretionary.
Mr Buiter: Not discretionary in the sense of opportunism, but one can be flexible in the sense of responding to news while doing so in a predictable way. That is what the authorities should do. They should follow rules which permit the response to news about economic developments at home and abroad.
Chairman: Having said that the concept was meaningless, I think you gave us a very good explanation of a sensible meaning that could be attached to it.

Q391 ***Lord Skidelsky:*** A view which a lot of people have is that one of the functions of good fiscal rules is to avoid putting up the pressure on interest rates. Is the challenge of both devising and sticking to good fiscal rules inherently more difficult in the EMU or in euroland than it is in the UK, where you have divided responsibility and no government?
Mr Buiter: I do not accept the basic premise that one of the aims of fiscal policy is not to put upward pressure on interest rates. There is nothing intrinsically wrong about high or low interest rates. Savers love high interest rates. Investors hate them. The right balance all depends on whether we have a low saving and high investment economy, in which case you would see higher interest rates, or a high saving and investment economy, in which case it would be the opposite. I do not think the purpose of fiscal policy is to lower interest rates. We are not here to maximise investment. We are here to maximise economic wellbeing which is about consumption tomorrow but also consumption now. There is

nothing wrong with some pie today as well as pie tomorrow. I do believe that fiscal policy should not produce false and erratic signals in the financial market. It should not set up a path for the public debt that will call for painful, abrupt corrections in the future. For the rest, whether we live as a high interest or a low interest economy, I can live with both. It all depends on the fundamentals that drive these interest rates. A low interest rate economy can be had in the midst of a great depression. I would not use the interest rates as a measure of the success of fiscal policy. I would want to check whether the government finances are taken care of efficiently and without threatening solvency and without exacerbating unavoidable fluctuations that a capitalist market economy always has. I would not have any great ambitions beyond that.

Q392 ***Lord Barnett:*** You know that there are a number of major countries in the European Union like France and Germany that have problems meeting the stability and growth pact targets and there are major fiscal and monetary deficits in the United States that some believe might well come to an abrupt end at some point in time. How do you think both these factors will affect the UK's fiscal and monetary policies?
Mr Buiter: Not in any obvious way. The situation on the continent of Europe, in France and Germany especially, and in the US is quite different. What has been violated in France and Germany has been the fiscal norms of the Stability and Growth Pact. Since these norms are essentially arbitrary, that is not in itself a cause for worry. It is a cause for worry only in the sense that here was an agreed upon set of rules and the first time they pinched people decided to ditch them. Ditching bad rules is probably better than sticking to them but not as good as sticking to good rules. In the US, we have a large and rising deficit. Unless there is a growth miracle in the rest of the decade, unless we see growth rates at the level we saw during the height of the tech boom, the current fiscal stance in the US is unsustainable, with massive increases in expenditure, not just on things that are clearly unavoidable like defence and homeland security. We have had a massive increase in the scale and scope of the welfare state in the US through the increase in public money going towards paying prescription charges for the elderly. The grey lobby has blown a big hole in the US budget and that is combined with tax cuts that were made partly for efficiency and partly for distributional reasons. The result is a situation that cannot last. They will have to either raise taxes or cut spending or both before long, or face ultimately a debt crisis.

Q393 ***Lord Barnett:*** You may not have been fortunate enough to be present when Ed Balls delivered his 20 page speech recently, but can I assume you have read it?
Mr Buiter: Yes.

Q394 ***Lord Barnett:*** Whatever we think about it, it was an important statement of UK government policy. In practice, as you know, the bad rules were sensibly ignored by France and Germany, given their current economic position in the cycle, but Ed Balls seemed to be arguing that he would not be opposed to the idea of an SPG provided it is more like our Golden Rule. In other words, an evolution towards a more sensible monetary policy and fiscal policy that the Chancellor is using at the moment. That is not part of the five tests. That has been made clear, but it is nevertheless important in the way the SPG runs. Do you agree with Ed Balls?
Mr Buiter: In some respects, yes. Clearly, the existing Stability and Growth Pact, apart from being arbitrary, is now dead as regards its applicability to countries already in the Economic and Monetary Union. It will still be used as a screening device for keeping out would be new entrants, especially from the east. Whether or not it should be replaced by another set of rules is an interesting question. There are those who argue—in my wilder moments I have argued so myself—that it may not even be necessary to have a common set of rules, that is, to centralise certain aspects of macro-economic fiscal management. If you believe that it is necessary, then yes, I agree with Ed Balls that there would be rules that would be much better and do less damage than the rules of the Stability and Growth Pact. I would not choose the version of the Golden Rule that is used here. That too has severe weaknesses. What really matters is that the government should be able to finance by borrowing, temporarily high spending, for whatever reason. If you have a permanently high investment programme, you cannot borrow to finance it, but the Golden Rule tells you that you can. You have to differentiate between a temporary increase in public spending and a temporary contraction of the tax bases that can be financed, and permanent ones that have to be met by either cutting other categories of spending or raising tax rates. I agree with Ed Balls that there are superior rules that it might be desirable to sign up to. Whether I would choose the current set of rules in the UK or go for something slightly more ambitious I would have to think about.

Q395 ***Lord Marsh:*** Is there not something fundamental in this particular example of the failure to accept the Stability and Growth Pact in that all central bankers have a problem with politicians and politicians have a problem with central bankers? This

is a unique situation where you have a central banker who has a multiplicity of governments and when that situation is difficult for them they will almost inevitably put their national interests first as they did with the presidency. You are much closer to it than I am. Do you think this is a fundamental, potential flaw?
Mr Buiter: I think the problem is no worse than it would be if you had 12 central banks facing 12 national monetary authorities. I agree there is a problem. There is an inelegant collision between a central bank making monetary policy for the euro area as a whole and the national ministries of finance believing that the world ends at the border, at least as regards the interest it takes into account in reaching its decisions. In some ways, the situation might be worse for the behaviour of the whole if, in addition to 12 national fiscal authorities minding their own business, you also have 12 monetary authorities targeting national inflation rates without any regard for the behaviour of the regional economy.

Q396 ***Lord Marsh:*** That is not a problem facing us.
Mr Buiter: I do not see that the problem created by the inability to coordinate monetary and fiscal policy inside the eurozone is any greater than it would be if there were 12 national, independent monetary policies in addition to 12 national fiscal policies.

Q397 ***Lord Roll of Ipsden:*** Do you think that expert knowledge of monetary economics is an essential requirement for membership of the Monetary Policy Committee? It may sound an absurd question but I ask it prompted by the fact that recent appointments to the Monetary Policy Committee do not seem to correspond to that criterion. Things may have changed in that regard since you were a member of the Monetary Policy Committee but what is your general view on this?
Mr Buiter: I am not going to comment on the qualifications of individual members. As I understand it, there are basically only two criteria that have to be met for someone to qualify for MPC membership. You have to be an expert in the technical business of monetary management and you have to be independent. Being independent means two things: not just not beholden to sectional or other interests but also not easily pushed around by vague notions of group harmony, consensus, unanimity, the kind of stuff that traditional central banks, where dissent is an ugly word, engage in. All the past and current members that I have known certainly are independent in the sense of not being beholden to any interests. The ones I know are also independent in not seeking consensus for its own sake. On balance, there has been a reduction in the purely technical competence in monetary policy skills on the Committee. There are fewer experts in monetary policy on the Committee now than there were in my time. I sound like an old duffer when I say that, but in my days things were better. Children and small animals behaved. I am not the only one who has commented on it.

Q398 ***Lord Vinson:*** Are they running out of candidates, do you think?
Mr Buiter: The nice thing about the criteria is that they do not even require you to be British. I was not at the time when I served. I am now, but I was not then and neither was DeAnne Julius. The world is a big place. Even within the UK, there are a large number of hitherto unused monetary experts so I do not think you are going to run out at any time soon and then of course you can go fishing in the global pond.

Q399 ***Chairman:*** Clearly we do not want to talk about individuals but when you started the Committee contained people and if one said, “I want to know about this” one would go to some of the people on your Committee when discussing this kind of policy making. It is not obvious that the Committee is now composed in that same way.
Mr Buiter: There are fewer recognised experts in monetary policy on the Committee now than there were before. Why that is I do not know. There are numbers of people—one of them is sitting here, in fact—who would do very well.

Q400 ***Chairman:*** You say there is no shortage of the sorts of people we might be looking for?
Mr Buiter: No. We do not have as many as we would like within the country because of the deplorable state of the academic sector in this country and universities in general, but there are enough even in this country. If you take a wider view in Europe and the world, you will not run out.

Q401 ***Lord Oakeshott of Seagrove Bay:*** You say there are these two criteria. These are not set down anywhere, are they? Are these just what you observe to happen?
Mr Buiter: I certainly remember having it said to me, almost from the day I joined the MPC, by the people who appointed me that there were these two criteria: technical competence and independence.

Q402 ***Lord Oakeshott of Seagrove Bay:*** I do not think they are in the Act, are they? Do you think it would be a good idea that they should be set down publicly?
Mr Buiter: It would not hurt, but we know what happens with the letter of the law.

Q403 *Lord Oakeshott of Seagrove Bay:* There is very little set out specifically either on how or why people are appointed.
Mr Buiter: It might be a good idea to have these two criteria.

Q404 *Chairman:* As an old duffer myself, I have to say that standards really have fallen since I stopped teaching!
Mr Buiter: Same here!

Q405 *Lord Marsh:* Given your unique position, how useful do you find the minutes of the MPC? As an addendum to that, it has been suggested that it might be helpful if they had a press conference at the end, where people could ask questions, or might that prove unhelpful?
Mr Buiter: I have to make a terrible admission: I do not read the minutes of the MPC. I stopped reading them the moment I quit the Committee, because they do not make riveting reading and because I do not make a living trying to anticipate interest rate movements. That is the only reason to read them. For that they are quite useful. Press conferences? Please, no. That would bring us to the pre-cooked manipulation of the assembled journalists. To have a press conference straight after a meeting of the Committee or to publish a long statement supposedly of what went on in the meeting, we know that these things have to be pre-cooked well before the meeting. It is much better to wait until we can publish the minutes of the meeting and then have individual members or the governor in the appropriate fora here, in the House of Commons or in lectures explain what they are doing. Press conferences are circuses and they are meant to manipulate the public. I do not like them at all.

Q406 *Chairman:* You are aware that the ECB does have a press conference?
Mr Buiter: Yes. They are just pre-cooked events that pretend to inform but do not.

Q407 *Chairman:* The GDP data is subject to very considerable revision in our country. I think it is a broader problem anyway. The question of timeliness has been brought to our attention on this, but the revisions do seem large compared with the frequent distribution of the actual changes when we eventually get to them. In terms of the way the MPC or any policy maker works, is this a serious constraint on the ability to make policy?
Mr Buiter: We cannot say that the revisions are large relative to the actual movement because the actual is simply the latest revision. We have no idea whether this converges to the underlying truth. I have absolutely no idea whether the final estimate of GDP is any closer to the unobservable national value added than people started off with. We are like the proverbial blind man looking in a dark basement for a black cat that isn't there. It just means that you have to look at other data sources that can confirm or reinforce or reject the interpretation of GDP data. There are retail sales data and other data based on smaller samples. GDP data are also based on samples but they are really big samples. I do not think these things ever work very well. It is not a unique problem here. The Japanese data, if it is any comfort, are much worse. They only tangentially relate to the real behaviour of the underlying economy. With more resources into not just collecting GDP data but thinking of ways in which relevant information can be brought to bear in real time on decision making, that would be money well spent. A few million on better data, if it leads to one less goof in monetary policy, would be money well spent.

Q408 *Chairman:* Is your argument based on the view that we need to know better where we are, or is it based on the view that we need to know better where we are going?
Mr Buiter: Both. We need to know where we are. It is very hard to predict the future if you do not know where you start from.

Q409 *Chairman:* The Bank has this new model for forecasting but a great model with the wrong data is not exactly the best way to do the job.
Mr Buiter: Indeed.

Q410 *Lord Vinson:* I take your point that revisions are more or less inevitable. Could I broaden it to look at the retail price index data? Are you happy both here and in the eurozone that the qualitative improvements in products are sufficiently taken into account when you are assessing price rises and other things? In other words, is there a tendency to overstate inflation through failing to take into account qualitative improvements in certain products?
Mr Buiter: I think the consensus is yes. How big is again something that one can never establish with any great degree of confidence. Of course, for certain goods and services, there is quality deterioration. On balance, trying to see how the characteristics we really care about are produced more efficiently by the underlying commodities that are purchased is a very inexact science but I do not think that necessarily leads to huge policy errors. What is worse is that the RPIX, while it did include some attempt at allowing for housing cost inflation, did it the wrong way and that the Consumer Price Index has no allowance for the cost of housing services at all. That is one way of solving the problem but it is unlikely to be very helpful. I am really worried about that, especially with the Monetary Policy Committee trying to figure

out whether house price inflation is contributing to economic instability if they do not even know what house price inflation is. That is a real handicap. I think there are real problems with the data and as a matter of urgency we must work on improving it, especially in the area of bringing rental rates and the implicit cost of accommodation into the price index. Without that, we miss a very large part of the spending package and this can have systematically distorting effects, as I think it does in this country. For the rest, there will be an infinitely lived research programme to improve our practical approach to quality change and new products. It will never be over but at least we should be able to stop ourselves from falling further behind.

Q411 ***Lord Elder:*** You have perhaps given some views as to whether or not you think this issue is something which can be practically measured, but there have been a lot of concerns about the emergence of the strong growth in the housing market and whether or not that will have an effect on macro-economic stability. Do you share the OECD's view recently expressed that early monetary tightening would help reduce interest rates and do you think that would be worthwhile?
Mr Buiter: I do not share that view. 50 basis points or even 150 basis points in a housing boom is tackling an elephant with a peashooter. These are assets that have lives of 25 to 30 years, on average. What is an increase in Repo rates going to do to that, if you only commit yourself for a month, unless the markets are massively myopic and their views of the rest of eternity are coloured by what the Bank of England is doing today? Interest rate changes should not be rationalised because of a desire to influence the housing market. I am not yet convinced that there is much to worry about. What we are seeing to a large extent is a response to a lowering of the long run real interest rate in this country. For these long lived assets, this can lead to massive revaluations. It does not happen overnight, and there is always a danger of speculative excess. I have no problem with the current levels of the key multiples. If you combine the lowering of the nominal interest rates with the extreme restrictions on the supply of new housing in this country, plus the fact that the country is getting richer, non-traded prices are going to go one way and that is up. By and large, housing is non-traded although those of you with houses in the South of France probably see it as traded. (a) I am not that worried about it yet. (b) Even if I were worried, I would not tackle it with monetary policy.

Q412 ***Lord Vinson:*** In as many words, you are suggesting that to tackle the housing shortage through monetary policy is to tackle the symptoms rather than the causes, the causes being as much as anything excessive land rationing through the planning system. It seems to me that we are often diverting a lot of effort into solving the housing problem and its effect on the economy by tweaking interest rates when the primary cause is excessive land rationing.
Mr Buiter: I am merely pointing out the consequence of land rationing. You might want to protect the black badger or something like that and not sacrifice land. That is the choice you make but you pay the price in terms of rising relative housing costs and that is part of what we are seeing in this country. It is clear that if there were less restrictive zoning laws there would be many consequences, environmental perhaps as well, but one of the implications is that housing prices would be lower.

Q413 ***Chairman:*** In this general area of alleged excessive borrowing, do you make the rationality assumption which economists make in this area, namely that people who borrow know they are going to have to repay and in some sense the system is self-stabilising, or do you make the assumption that seems to lie behind a great deal of the commentaries that we read, which is that the borrowers are completely irrational and have no idea that they are going to have to repay?
Mr Buiter: Unlike many emerging market governments, private borrowers know they will have to repay but they may greatly underestimate the risk of a significant change in the real cost of repaying along the road. I do not think people are irrational; they are just often not very well informed. It has more or less the same effect but it is not the same thing. If you look at both household and corporate gearing ratios, they have gone up. If you do the gearing ratio relative to the inflated value of the housing stock, you may be hiding problems, but even if you take debt service requirements, interest payments, as a fraction of disposable income, things do not look crazy yet. What can you do about it with monetary policy? If anything, this is a task for regulatory policy: make it less easy to get credit, strengthen collateral requirements and those kinds of things. You may even, as policy makers, jointly between the Bank and the Treasury, engage in open mouth policy, but interest rate changes will not make any great difference.

Q414 ***Chairman:*** Those who argue that way must be making the assumption that economists are particularly good at knowing what the right rate of borrowing for the economy is. I know of no economists that tell you that myself. Can you guide us?
Mr Buiter: You can *ex post* always point out how the now bankrupt enterprise or bankrupt consumer got into trouble, but it is very hard to do it *ex ante*. There

is too little proper vetting of creditworthiness by banks in consumer credit markets but it is a regulatory problem. I think it has to be tackled through those channels and not through monetary policy.

Q415 ***Lord Vinson:*** Could the Chancellor tighten the capital adequacy ratios for the banks to make it less easy for them to lend 100 per cent and interest only mortgages and the like? Would you suggest that he should have those powers?
Mr Buiter: He would lose friends very quickly in the City because it would put the British based banks at a competitive disadvantage vis a vis foreign banks, but there are things that you can do that restrict the lending ability of all banks operating in the country, whether they are based here or just foreign subsidiaries. I think things can be done there. There are ways in which a down payment that is required for a consumer loan could be increased or collateral requirements, the ability to borrow against the equity in a house, can be restricted. It is all there for the asking. While in the fullness of time most of these controls will be intermediated out of effectiveness, you can have a law that is sufficiently broad in spirit so that you can keep putting the newly innovated escapees from the corset inside the corset again.

Q416 ***Lord Sheldon:*** Do you not think that long term economic stability has something to do with all of this? People have had seven years of economic stability and they take it for granted now. In the past, they did not always take it for granted, and there were a number of people who were a little apprehensive about what the future might bring. That apprehension is rather less now than it has been in the past.
Mr Buiter: I think you are right. We saw that in spades in the United States, especially with the last bull run in the stock market. There was a whole generation, not just of private investors but of professional traders who believed that markets only went one way, upwards. This is the same type of thing. If you have not seen a recession and unemployment above 5.5 per cent in 10 years or so, if you do not know that interest rates are at the lowest level since the early post-war period, I think you do underestimate the risk of either worsening employment opportunities which of course is the greatest immediate threat to people's ability to service a debt, or a drastic fall in asset values which, while it does not create immediate problems for servicing a debt, may make it harder to roll over a debt when it becomes due. It is one of the reasons that the old, pre-Keynesian business theorists talked about the purging value of recessions and downturns. It gets the excess out of the system. If you have too much for too long, the quality of decision making goes down both by lenders and by borrowers. It increases the vulnerability and the risk of an eventual, more severe downturn. Yes, I believe that is true.

Q417 ***Lord Oakeshott of Seagrove Bay:*** My question is about a corset as well. How likely do you think it is that the government will burst out of its own self-imposed corset, the Golden Rule, in this cycle, without having to raise taxes?
Mr Buiter: The Golden Rule is defined in a cyclically correct fashion and that is a great safety valve because your view of the cycle is as good as mine. If you take non-partisan projections based on reasonable assumptions about where capacity output is or about the natural rate of unemployment, you see that it is not a done deal that the Golden Rule will be violated, but there is a real risk in the next couple of years that it might burst through. My response would be a big "So what?" I think that, much like the Stability and Growth Pact rules, the Golden Rule also has to be repondered. If the reason for bursting through the Golden Rule barrier is temporary and curable, then I would not worry about it. It is not quite even odds but it is quite possible within the next two years that the Golden Rule barrier will be breached. I still would not ring any alarm bells over that.

Q418 ***Lord Oakeshott of Seagrove Bay:*** On the one hand, you are saying, "So, what?" and I have some sympathy with that but, on the other hand, I think you are saying that we need to redefine it or look at it in a different way. Can I press you on that.
Mr Buiter: I think you must really get a better sense of which changes in expenditure are likely to be permanent and which are likely to be transitory or even reversed. Similarly, if there are changes in tax revenues, we have to figure out whether this temporary buoyancy is due to temporary tax base broadening or whether there has been a permanent increase in the efficiency of tax collection and all that kind of thing. The real Golden Rule in economics is finance what is temporary, tax or cut other spending to take care of what is permanent. That rule is not synonymous with the Golden Rule. It is only synonymous if all investment is temporary. While this country may not need a very much higher level of investment forever, given the way that infrastructure in this country has been allowed to go to pot over the last 40 years, it will take decades and decades of much higher levels of public sector investment in infrastructure (transportation especially) in order to make up the shortfall. Since this is going to be, in my view, a process of decades rather than years, you ought to certainly plan for financing most of it through taxes at some point rather than thinking you can safely borrow for this.

Q419 ***Lord Barnett:*** The Chancellor's Golden Rule is concerned with the cycle. You seem to be saying that you do not mind if the cycle extends to decades rather than a few years.
Mr Buiter: No, I am saying the opposite. The borrowing component should be smaller, the more persistent, the more durable the spending increases. Since the public investment increase, in my view, should be very durable, we should not borrow for most of it but rather tax for most of it or take it out of expenditure elsewhere.

Q420 ***Chairman:*** So, taking an example, but not necessarily one on which you have taken any view, if the country were moving to a higher path say for the NHS, then broadly that is also a commitment to raise that much tax?
Mr Buiter: Absolutely.

Q421 ***Chairman:*** That is the rule.
Mr Buiter: Very much so. It is an excellent example in fact. If you are going to make a decision that healthcare at the point of delivery is going to be free and financed out of general taxation, then you can have a permanent increase in, say, the National Health Service spending as a share of GDP, but you had better finance it either out of taxes or through other spending cuts. . . . You cannot borrow for that.
Chairman: That clearly fits. Finally, we get on to our last question.

Q422 ***Lord Sheldon:*** Talking about governments in general, do you believe that they know how to improve growth in productivity and is this something that governments can do and what do you think of the approach of our own government in this? Can it be done?
Mr Buiter: Like all good questions in economics, the answer is "yes" and "no". It is clear that governments can destroy productivity growth very easily. In the countries in which I work now, certainly in Eastern Europe and the former Soviet Union, we see examples of what can be achieved with the right government policies, if you take Estonia for example, but, also that with always the wrong government policies, you get Uzbekistan. It is decline and stagnation in the latter, and in the former a country that is bursting with growth. My answer is not going to be terribly original, but one thing governments can do and must do is provide a framework for macro-economic stability. I know that sounds like a bore but that is really true! So, monetary and fiscal policy must work in tandem—that is clear.

Q423 ***Lord Sheldon:*** We have had seven years of it.
Mr Buiter: Yes and that is good and that is why we have had high growth. It may even raise trend growth rates because greater stability engenders greater efficiency and higher investment rates, so it can make a permanent difference not only to the levels but also the growth rate of GDP. Beyond that, there is very little that can be done. Deregulation, getting out of the way of the private sector, is something that is, by and large, a good idea, although it is important that the right kind of regulation remains in key sectors with natural monopolies and that tariff schedules are appropriate. For the rest, governments have to take care of the physical infrastructure and the human capital stock. These are of course a major challenge in this country. We are way behind compared to the rest of the industrial world in terms of physical infrastructure, especially transport. In the educational system, there are a few islands of excellence in a sea of mediocrity, I think compared to all your continental competitors now. That is a problem. There is a paucity of general, non-specific inducements to innovation either through taxation or through broad-based non-selective subsidies. Encourage R&D but do not target it, in detail do not micromanage it. The one thing that governments should not do—and this is a weakness of all governments but particularly in these past seven years here—is to micromanage in great detail tax, expenditure and regulatory incentives. I think that does a lot of damage because it involves considerable transaction costs for businessmen and for entrepreneurs. So, get a simplified and stable tax structure. Do not tinker with a thousand little tax incentives here and a few wedges there. The European Commission has published a very interesting study of the poverty trap, the unemployment trap and the "why work" trap. We may not be the worst—in fact we came out of it quite good, relatively—but it was still atrocious because if you look at the combined effective marginal tax rate on households of various compositions, combining subsidy withdrawal and explicit taxes, you have massive distortions in the tax/benefit system that stem from the concatenation of hundreds of little taxes, subsidies and allowances. Nobody can understand it, it does not make any sense, but, each budget, you get 300 more I think that, if the Government went out of their way and stopped micromanaging details of the tax structure and of the subsidy structure, they would do everybody a favour.

Q424 ***Lord Sheldon:*** We have had economic growth with economic stability. What we have not had is the growth in productivity and it is this that, after seven years, one might have expected. If there were a connection, we would have seen it by now.
Mr Buiter: There has been no significant change in the growth rate of productivity here but since the continent of Europe, or at least the large countries in Europe, saw a significant reduction in the growth of productivity, we did not necessarily do that badly. Of

course, it would be nicer to be able to share the experience of the United States over the last 10 years. Remember, however, that they went through 30 years of below average productivity growth before that. It is very hard to understand what really drives productivity. We know of the negative factors, but we cannot manage it and certainly not micromanage it. All we can say is, "We will go away and have a good regulatory framework which will be simple and transparent with low tax across the board and then just come and get it." Take care of the infrastructure and take care of the educational system and, for the rest, governments should not have grand strategies and not attempt to pick winners, because that is where disaster lies.

Q425 ***Chairman:*** It is rather like Karl Popper's dictum—it is very hard to do good but it is much easier to do harm and therefore the best policy starts by saying, "Let's not do harm."
Mr Buiter: That would be a very good start.

Q426 ***Lord Vinson:*** I want to raise the question of the effect on productivity of the limitation of working hours. In my own background, I know that, for example, overtime, provided it is done with the agreement of the workforce concerned, is the most efficient way of bringing supply and demand into the balance and any limitation on the sensible working hours of people in the economy seems to be hugely damaging or would be.
Mr Buiter: I do not know if it is hugely damaging but it is certainly unnecessary and silly, so I think the Working Time Directive is just an own goal. I do not think it is a major own goal because I do not actually think it bites because most people who are really affected by it try to get around it, but it is just one of the examples of productivity destroying regulation and legislation.

Q427 ***Lord Vinson:*** They are talking of tightening it.
Mr Buiter: I hope they do not because it should just be phased out.
Chairman: That is a very good note on which to end. You can tell how indebted we always are to you. I am particularly glad that, given your definition of independence, you have not lost the independent frame of mind! It was very good of you to come. Thank you very much.