A New Theory of Economic Growth
Transcript

Date: Thursday, 15 November 2012 - 6:30PM
Location: Chartered Accountants' Hall
A New Theory of Economic Growth

Professor Douglas McWilliams

Thank you very much for coming to join us. I am sorry that we have had to change the venue - the original venue was going to be overfull. I hope that you have not been put to too much inconvenience from the change in venue.

I would like particularly to thank the Institute of Chartered Accountants in England and Wales, and particularly the Chief Executive Michael Izza and his staff, for making this wonderful hall available to us this evening. Both Gresham College and I in particular are extremely grateful to you.

Tonight we have the most technical in the series of lectures this year, though my objective is to keep the level such that an intelligent layman can keep pace with the argument.

When I was a young economist at the CBI, I was in effect apprenticed to the CBI’s then Chief Economic Adviser, Sir Donald MacDougall. He taught me much of what I know about practical economics. Donald was a very good economist who had been involved in major events. Probably most important of all of these was the work he carried out under Lord Cherwell in the war in the statistical unit in Churchill’s war bunker and which had a considerable influence on the Battle of the Atlantic during the war through his work on shipping losses. Had he got it wrong we might have been listening to this lecture in German. Or more likely not listening at all, as I don’t think that someone with my tendency to be fairly frank about what is going on would have got very far under Nazi rule.

Donald served again as Churchill’s economic adviser after the war and was the government’s Chief Economic Adviser in the late 1960s and early 1970s before joining the CBI as Chief Economic Adviser. I had the good fortune to succeed Sir Donald as the Chief Economic Adviser to the CBI and to speak at his memorial service at Nuffield College, Oxford. Donald was always very conscious of the balance of payments constraint as an issue affecting economic growth and wrote many of his books on the problem including what is probably his major work ‘The World Dollar Problem’ [1], and since this is the theme of this lecture, I am dedicating it to his memory.

Donald’s memoir, ‘Don and Mandarin’ [2], tells of his excitement when he visited Cambridge to hear an early prepublication version of Keynes’s General Theory while he was a postgraduate student at Oxford in the 1930s.

Keynes’s thinking is an important part of this lecture. Keynes died prematurely in 1946, probably worn out by his huge efforts during the war and his post war reconstruction work, and I never had a chance to meet him, but I feel through Donald MacDougall that in some way I have a link with him and I keep a copy of his General Theory on my desk at work. I have always been happy to call myself a Keynesian, though I think Keynes was a much more considered man than some of his unthinking followers. He remains, with Adam Smith and Karl Marx, one of my three economics heroes.

Keynes was a man of many parts, married to a ballerina from Diaghilev’s company, and who invented the Council for the Encouragement of Music and the Arts which became the Arts Council. My other link with Keynes was that a rector of Lincoln College, Oxford, my alma mater, was Lord Trend, and he had worked as the private secretary to the Chancellor of the Exchequer in 1946. He told me that Keynes (who at that period was effectively co-Chancellor, negotiating the American loan to tide Britain over after the war, and who therefore worked in the Treasury) introduced him to opera, one winter evening walking all the way across from the Treasury to Covent Garden and back to get him tickets for an opera that he had particularly wanted Trend to see. Even today this would be quite a strenuous undertaking for a prematurely aging man, and in 1946 through the London smog of the pre-clean air act era it would have been much more so for a man within a few months of his death. I think this says quite a lot about what sort of man Keynes was – Burke Trend remained impressed for the rest of his life by the memory of this great man going out of his way to help a young civil servant.

I have been helped a lot in my career by two other economists who are here this evening – Dermot Glynn – who was my first boss at the CBI and who sweated some blood both to make me a better economist and to cope with my exorbitant pay demands during the inflationary 1970s - and Sir Samuel Brittan, who was the journalist fellow at Nuffield College when I was doing my post graduate course, and who helped me turn from speaking mathematics to something resembling English through countless late evening discussions. He also opened my eyes to many parts of modern free market economic theory that had been (presumably inadvertently) overlooked by my Oxford tutors. Sir Samuel also played the part of Keynes with Burke Trend by introducing me to opera and one of my fondest memories is his taking me and my newly affianced wife to be, Ianthe, to Glyndebourne to see Sir Peter Hall’s production of Fidelio, which remains my favourite opera.

Donald MacDougall was immensely helpful to junior economists trying to make their way in the world and showed what in retrospect looks like extraordinary patience with us. He has been a very good example to me and it is one that I try to pass on to the next generation of economists with whom I work. And so this evening I have invited Charles Davis and Oliver Hogan, both of whom work with me as managing economists at Cebr and with
whom I have developed much of the thinking embodied in this lecture, to join me to cover particular parts of the talk.

Charles is our chief macroeconomist and has been in charge of Cebr’s economic forecasting for much of the time when we have had the best track record in the country for forecasting GDP and so it is right that he covers the section where we look will look at the forecasting track records for those who have not been using our ‘new’ growth theory. He will also cover the two official reports on forecasting errors prepared by the OBR and the Bank of England and released in the past month.

Ollie is our chief microeconomist but he will take us through a macro topic, the foreign trade multiplier, which is not a brand new theory but one the relevance of which has radically changed. He and I have discussed this at great length and his mathematics is much better than mine (at least now), so he has developed the argument and expressed it in mathematical form. But don’t worry – he also speaks English, with that facility for words that seems to be the counterpart to an Irish heritage.

**Summary**

My first two lectures have provided the raw material for this one. They have developed three concepts: The supercompetitiveness’ of the emerging economies; The continuing shift in the terms of trade in favour of primary products and away from finished goods and services; and the likelihood that overall world economic growth will be constrained because of limits from the lack of natural resources, meaning that some of the enhanced economic growth in the emerging economies will be at the expense of lower growth in the mature economies.

The first lecture two months ago concluded that the Second Great Transformation – the industrialisation of two thirds of the world’s population – was indeed the greatest ever world economic change.

The scale of the shift in advantage was remarkable, but even more so the speed of this. Essentially China is achieving in 50 years what it took us more than 150 years to achieve. One of the consequences of this has been that attitudes in the emerging Eastern economies have adjusted more slowly than they might have done had the pace of economic transformation been slower. And so there is a discontinuity between economic behaviour and economic performance. One of the consequences is that the emerging economies have become supercompetitive because they have not allowed their emerging prosperity to blunt their economic edge.

In the second lecture, we showed two things with the benefits of the expertise from a minerals expert and an energy expert: first, it was likely that the terms of trade between final products and commodities on the one hand and primary products on the other were likely to move in favour of primary products, causing their prices to rise in real terms for at least an extended medium term even if in the very long term the elasticity of the supply curve eventually reasserts itself; and second, that there would be limits on the total pace of world economic growth caused by the potential inflationary impact of primary product inflation if growth were to accelerate too rapidly. This implies that to some extent the supercompetitiveness of the emerging economies comes at the expense of existing economic activity.

**The underlying analysis**

Tonight we turn to the next step of the argument.

If the future growth in the world economy is to have these three important characteristics what determines the growth prospects for the mature economies?

And if – as is the case currently – these growth prospects do not appear strong, what can be done best to improve the situation?

**Traditional theories of economic growth**

This new theory is not really a new one – it is just an old one whose time has come.

One of the distinguished economists to whom I showed the draft of this lecture said that if a theory was true, it must be true for all time. They cannot come and go like fashion in clothes.

I think this would be a fair point to apply to a scientific theory of how the world works which is meant to be a complete and true explanation.

But economics is just a way of describing how people behave in one particular sphere. Economic theories are simplified models of the real world. And the relevance of the excluded variables changes, just as the way in which people behave changes. When I was young, most boys wanted eventually to own a fancy car. Now they want fancy digital gadgets. Two things change – people’s behaviour and the economic factors affecting that behaviour. So whereas scientific theories should be true for all time, economic theories can be more or less applicable depending on the circumstances.

The current mainstream growth theory distinguishes itself from what is often called business cycle analysis by focusing on the determinants of long term rates of growth in economic activity. Built into this theory is the concept that over the business cycle, the economy generally returns to a mean (in fact most of them assume that economic activity returns to where it would have been), and underutilisation of resources largely disappears.
This is what generates the ‘mean reversion’ that seems to be built into Treasury and OBR forecasts.

The three characteristics of modern growth theory are: Growth in the medium to long term is determined by the availability of resources of labour and capital, and the productivity with which they are used; Inflation is determined with respect to an inflation augmented wage equation, where wages (or more precisely the rate of change of wages) are determined by labour market conditions and expected inflation (this is sometimes called the expectations augmented Phillips curve – the Phillips curve being a crude representation of the short term relationship between inflation and unemployment); and the labour market condition which makes inflation non accelerating is called the NAIRU – the non-accelerating inflation rate of unemployment.


One of the implications of this theory is that if there are underutilised resources, they will bring down inflation below its intended level and which in turn either through the monetarist route of creating excess real money balances or through the Keynesian route of permitting additional policy expansion causes the economy to grow again. Because the economy will automatically right itself, you can look at growth in the long run as determined by the supply side – the factors of production.

Part of the credibility of this approach is that it seemed to describe well what happened in the UK in the 1980s, when many academic economists had argued that the economy would continue to be depressed after the severe counterinflationary squeeze imposed when Mrs Thatcher became Prime Minister. Indeed the ‘gang of 364’ academic economists wrote to the Times in a letter originally dated Friday 13 March 1981[7] after the 1981 Budget claiming that:

‘(a) there is no basis in economic theory or supporting evidence for the Government’s belief that by deflating demand they will bring inflation permanently under control and thereby induce an automatic recovery in output and employment;
(b) present politics will deepen the depression, erode the industrial base of our economy and threaten its social and political stability;
(c) there are alternative policies; and
(d) the time has come to reject monetarist policies and consider urgently which alternative offers the best hope of sustained recovery.’

Unfortunately what the gang of 364 forecast turned out to be largely wrong – the economy not only did recover of its own accord but did so remarkably soon after these academic economists had made their predictions!

Although in their favour, it must be said that fiscal and monetary policies were relaxed surreptitiously, with interest rates being cut and the budget deficit being allowed to rise somewhat compared with the plans in the 1981 budget. A sort of Plan A+, though the Thatcher and Howe rhetoric disguised the fact.

Although the ‘gang of 364’ got their forecasts wrong, they were probably right about the damage done to the supply side of the British economy by the squeeze – but I still think that it would have been difficult to get inflation down by any other route.

The episode did much to undermine both the reputation of academic economists and Keynesianism, although in my view Keynes would not have signed so stark a letter. Donald MacDougall, then aged 91, told me over lunch a few days before he died that he certainly would have done so had he not thought it politically inappropriate for a CBI Chief Economic Adviser to get so involved in such a partisan manner.

Through the 1980s and for some of the 1990s, the Treasury economists initially under the then Terry Burns, now Lord Burns, had a remarkable track record in accurately forecasting the economy that contradicted the dismal expectations of the so-called Keynesians in academia.

But in the present century their forecasts have got worse. First, the financial forecasts for government borrowing deteriorated started to become seriously overoptimistic. Then after the financial crisis, the GDP forecasts also became overoptimistic. Even the hiving off of the Treasury forecasters in 2010 to provide a new ‘independent’ body called the Office for Budget Responsibility or OBR has failed to improve the performance which has in fact further deteriorated.

The stimulus for this lecture came from what was in effect a challenge from the current head of the OBR, Robert Chote. I asked him at last year’s post Autumn Statement press conference why his forecasts still incorporated ‘mean reversion’ the assumption that growth would return to normal automatically despite the emerging evidence that this would not happen. He said that he was bound to do so because of the statutory requirement on him to produce cyclically adjusted estimates of the budget deficit. In other words, what he was saying was a sophisticated version of that old joke that economists are there to prove that what works in practice doesn’t work in theory.

I’m not sure that Robert intended it as such but I took this as a challenge – if the theory doesn’t work – go get a new theory that does.
**Forecasting track record**

The reason why we need a new theory of growth is that the old one has failed. It has failed to predict what would happen. It has also partly failed by encouraging mistaken policy formulation.

An independent study carried out by the news organisation Citiwire claimed that in the 8 years to 2010, our own organisation, Cebr, and the economists at the OECD had jointly had the best forecasting track record for the British economy.

Last year, according to David Smith in the Sunday Times and other commentators as well, we were again closest to getting GDP right. This year, unless the ONS manage to produce something unusual for GDP in the fourth quarter, we won’t come top of the class yet again but we will probably be in the top 3 or 4 and should consolidate our lead in the long term track record. So we have credibility when we make criticisms of the official forecasting track record and suggest a different approach.

The slide shows how the Treasury/OBR forecasts short term forecasts have deteriorated, looking at the forecast a year ahead. All forecasts for GDP since 2008 have been overoptimistic. Moreover, only one forecast – for 2009 – in that period has even been within the normal margin of forecasting error of about 1%.

The next slide shows how the Treasury/OBR medium term forecast has been even more wrong, looking at the 4 year forecasting horizon. Again the forecasts have been badly wrong. The 2007 forecasts were wrong by a colossal 14% (mind you, the Cebr forecast from that time – though better than the others – was still pretty inaccurate). Even in 2008, when Cebr had understood roughly what was going on, the Treasury still got its 4 year forecast out by nearly 9 percentage points over the four year period. It is the 4 year forecast which is most affected by the Treasury assumption of mean reversion.

It is not just the Treasury who have been getting their forecasts wrong. This slide shows that the Bank of England has also made similar errors although because they do not look so far ahead, they have not had the same opportunity to get their forecasts so wrong!

Recently both the Bank and the OBR have had investigations into their forecasting track record. The Bank commissioned David Stockton, former Chief Economist for the Federal Reserve Bank, to look at its forecasting track record. This is quite a serious report which makes some good suggestions. In particular he picks up a key problem with the forecasting methodology.

His executive summary comments: ‘But some of the inertia exhibited by forecasts simply reflects the slowness with which forecasters spot deeper structural problems with the stories underlying their forecasts. In the MPC’s forecasting process, there are few mechanisms capable of acting as a trigger for a fundamental reassessment of the outlook. Some of the options presented in this review are intended to create more “speed bumps” in the forecast process that might disrupt its natural inertia—for example, the possible development of a staff forecast and an even greater engagement with external researchers and scholars’[8].

The OBR report on forecasting errors[9] is by its nature a much slighter piece of work. It essentially is based on economic accounting and shows where the errors were made, not why.

But both reports fail in that they do not get to the roots of the theoretical problems that have caused the forecasting failures.

Part of the problem in the Treasury/OBR and Bank of England is cultural. The types of people who gravitate to jobs in these organisations tend to have a degree of disdain for people who are in ‘trade’. They have some respect for people running large companies but look down on those from their own profession who in their eyes have demeaned themselves by sinking to the grubby task of making money.

Despite all my years of forecasting experience and with the last few years as the widely admitted champion I have never once been contacted by a Treasury, OBR or Bank of England official to ask my views on what is likely to happen. They claim that they take on the views of the outside world by looking at the average of consensus forecasts. But no one in the commercial world would judge themselves by looking at what they could learn from the average of their competition – the standard technique is to compare with the best of the breed – the top competitors.

I think there are two theoretical reasons why the official forecasts have been so bad. The first is that they failed to understand the long run implications of the financial crisis. The Reinhardt Rogoff work on this that showed that recovery from financial crises could take more than a decade initially only weakly permeated the minds of the official forecasters[10].

But the second reason is more fundamental and has affected particularly the medium term forecasts from the Treasury and OBR. The official forecasters have been working on a theory of economic growth that is essentially supply constrained.

I believe that the factors that have changed since the 1980s and part of the 1990s when the official forecasters got their forecasts right mean that for the foreseeable future, growth will be constrained by both supply and demand and a demand constrained theory is needed both for forecasting and economic policy formulation.
Balance of payments constrained growth
The key changes that have affected the world economy other than the aftermath of the financial crisis are the supercompetitiveness of the emerging economies, the change in the terms of trade away from primary commodities and the fact that world growth is constrained by the inflationary consequences of primary product prices that rise when the world economy puts its foot on the accelerator pedal. These particularly impact through the balance of payments, which is why our ‘new theory’ is not really a new theory at all but an old one that has become newly relevant.

The static balance of payments growth model was produced by Sir Roy Harrod[11] in the 1930s.

If $M = mY$ and $X=M$, then $Y=X/m$. So GDP is equal to exports divided by the propensity to import.

The dynamic version of this, known as Thirlwall’s Law after the distinguished economist Professor Tony Thirlwall from Kent University, is that the long run growth of a country can be approximated by the ratio of the growth of exports to the income elasticity of demand for imports[12].

Where the model needs to be developed is to take account of four factors: Inflation; an adjustable real exchange rate. For this to work, of course, the Marshall Lerner conditions have to be met. The condition states that, for a currency devaluation to have a positive impact on trade balance, the sum of price elasticity of exports and imports (in absolute value) must be greater than 1. But this is generally the case for small countries (and today most countries are in economic terms small) at least in the long term provided that inflationary pressure from the devaluation can be constrained; changes in the underlying competitive position affecting both exports and imports; and finally changes in the terms of trade.

The inflation model needs to be developed from the traditional Phillips curve to reflect the modern reality that inflation is increasingly heavily dependent on the prices of imported goods, including primary products, as well as on the price of labour in the domestic market. So the simple expectations augmented Phillips curve needs to have imported inflation added in.

The whole model therefore has these equations: A target for expected inflation; Inflation as a function of expectations and both imported inflation and the domestic market, especially the labour market; Imported inflation as a function of the exchange rate and exogenously given trend in import prices; A balance of payments that has in the long run to balance on some definition; A propensity to import (in volume terms) based on competitiveness which in turn is affected by the exchange rate as well as the competitiveness of other economies; Import values equal to volume times price;

A propensity to export based on competitiveness which in turn is affected by the exchange rate as well as the competitiveness of other economies; Export volumes a function of world trade and hence world GDP and the propensity to export; and Import volumes a function of domestic demand and implicitly domestic GDP and the propensity to import.

This is the simplified version of Cebr’s macro forecasting model. Indeed it could represent most short term forecasting models of the economy, which are essentially demand constrained. What is different is that we think the same approach is relevant for the medium term whereas the traditional approach has been to treat the medium term as supply constrained.

Policy
What does this mean?

The first and most immediately obvious point is that in a balance of payments constrained world, policies that have a particular impact on the balance of payments by cutting imports or boosting exports tend to have rather better multiplier effects than those that simply affect domestic demand.

This makes the case for policies that improve the UK’s trade competitiveness – which might be regulatory or tax based. For example, the returns from keeping down employers’ national insurance contributions are considerable. It is worth noting that Donald MacDougall while at the CBI led the campaign to end the National Insurance Surcharge in the 1980s, which he branded the 'Tax on Jobs'.

One potential way in which the balance of payments can be improved is through import controls of various kinds. I am not convinced that these can be applied successfully in the modern world, partly because of trade integration and partly because of international agreements. But even if they could be, and I accept that selective import controls can be shown in economic models to produce higher levels of GDP, normally devaluation with equivalent inflationary effects is better because it boosts exports as well as reducing imports.

Balance of payments constrained models were precursors of endogenous growth models in that factor supplies are endogenous. An interesting implication of this is that the supply of labour reacts to demand by much more than generally is assumed in traditional models. This has traditionally been thought of as people losing skills and becoming permanently unemployed. But if labour markets are flexible it might also be an explanation of how people have priced themselves into work in the UK to cope with the limited about of economic activity available. This would help explain why unemployment in the UK has risen so little during the recession given the scale of
Another point which may not be immediately intuitive but which follows from this model is that in a world such as the one that we have just described, the more the domestic contribution to inflation is reduced, the more scope there is to ‘improve’ the propensities to export and import through a lower exchange rate. And of course the real exchange rate is reduced doubly – by the lower inflation as well as the lower nominal exchange rate.

It is for this reason that measures like higher VAT, excise duties and administered prices, if they push up inflation, are actually likely to be counterproductive.

What does this model tell us about Keynesian fiscal and indeed monetary policy?

This is complex.

My sense is that the inflation objective is essentially to ensure that inflationary expectations do not bed in – since the experience of the past 50 years has shown us how difficult it is to remove inflation once it has embedded itself in expectations.

But as Sir Mervyn King’s Stamp Memorial Lecture[13] indicated, when inflation is generated by movements in primary product prices rather than wage inflation, there is probably scope to be more flexible with the range around the inflation target than one might be had inflation been a symptom of a labour market imbalance. When inflation is being generated by primary product prices, it is likely to be much more volatile than when it is being generated by wages.

I believe incidentally, that one of the reasons that fiscal and monetary policy was too relaxed for much of the 2001-08 period was the misleading signals generated by very low rates of increase in import prices, which of course hid for a period an emerging inflationary trend in the domestic economy within the policy regime of targeting consumer prices.

On an international scale I am relaxed about more expansionary fiscal and monetary policies in present circumstances when demand is being depressed by consumer and corporate caution and by deficit cutting measures in many parts of the world. So in that sense I am a Keynesian. In the Western world, the liquidity trap, which was Keynes’s key invention, does apply since interest rates are about zero (and cannot go negative) while asset price inflation is in many cases negative.

But Keynes’s General Theory was designed for a world with unemployment in major economies – the Lebergott series for unemployment[14] in the US shows the unemployment rate averaging about 20% in the 1930s and dipping below 15% for only one year (1937). It is also worth remembering that in the great depression, about which Keynes was writing, prices were generally falling. In the US, for example, the consumer price index fell by 27% between September 1929 and March 1933. The General Theory was also designed for a world where capital markets were not global. These differences mean that there are limits to the extent to which one can apply his preferred route of fiscal expansion to a small economy, where inflation is positive.

For the UK, which is now a small economy - about 3% of world GDP - one would have to be more cautious than one can be on a global basis, because there is a risk of frightening the financial markets which could lead to a weakening of the pound that would put the inflation objective (even if interpreted flexibly) at risk.

I believe that there is more scope to expand the economy fiscally while keeping the financial markets happy if it is clear that public spending is being reduced persistently.

Modern politics is based on perpetuating stories, some of which may be true, others less so. Essentially the present coalition government’s story is that it needs to cut spending because it needs to cut the deficit – and the electorate seems to agree in principle even if so-called fiscal nimbyism means that it is less enthusiastic when the deficit cuts affect it directly.

But actually, the case should be made that public spending under the previous government was taken well beyond the point of diminishing marginal returns. Public spending as a share of GDP rose from 36.5% in 2000 to 51.1% in 2009[15]. This has led to tax rises that have almost certainly damaged the UK’s competitiveness and hence potential growth. More controversially and less easy to prove, my view is that the country got precious little improvement in public services for the rise in the spending share of nearly 15% of GDP.

The case for cutting public spending has not been handled head on. Because it has been presented as an argument against running a deficit it has had two negative consequences.

The first is that if the deficit is the problem rather than public spending then tax increases are an adequate substitute for expenditure reductions. But they are not. I don’t agree with Ed Balls on much but I think he is right to point out the damage to the economy from the rise in VAT from 17.5% to 20% in January 2001. This was in my view one of the causes of the slowing down in the economy that became the double dip. Also damaging to the economy were the increases in higher rate tax to 50% announced by the previous Chancellor and the removal of the basic allowance for those earning more than £100,000 a year, creating a marginal rate of tax (including national insurance) of 62% for some – this has probably done more to encourage the midweek playing
of golf than any economic policy ever invented by creating a huge disincentive to work harder for the professional classes.

The second is that the deficit targets become inflexible – at least in theory – when the economic outlook changes. Having said that, the June 2010 Budget had a target for public borrowing for 2013/14 of £60 billion. The government has shown some flexibility by raising its target to for the year to £98 billion in the March 2012 Budget. But the position has deteriorated in the past few months and the Cebr forecast for the same period is now £127 billion. I do not believe that the government needs take additional action to accelerate the trend reduction in the deficit, though it should ensure that the planned cuts in government spending do take place. It would be particularly counterproductive to raise taxes further to hit a fairly arbitrary deficit target.

I think there is some scope with tight control of public spending to be slightly more relaxed about the pace of cutting the deficit and for cutting those taxes that do most to hinder the UK’s international competitiveness.

The final policy issue relates to this. Because interest rates are low, the main monetary policy instrument at present is quantitative easing in the form of the Bank of England buying gilts. The government now owns about a third of the gilts in existence.

Last week, in a carefully managed exchange of letters the Bank announced that it would be handing the interest paid on these gilts back to the Treasury. I see this as essentially an accounting transaction that does not on most definitions affect public net borrowing.

But it does open the door to the bank simply cancelling the debt.

Should they do this?

The first point to make is that under our theoretical framework, it makes no economic difference to the optimal policy. Our framework does not work off arbitrary debt GDP ratio targets and therefore the accounts, as it were, don’t have to be fiddled.

In the exchange of letters between the Governor and the Chancellor[16], the underlying expectation is that at some point there will need to be ‘quantitative uneasing’ as the debt purchased is sold back. Frankly, I think that if they expect to do this in circumstances where banks and potential borrowers remain as depressed as they are likely to for the foreseeable future and where targets for bank reserves are being progressively raised, then they are living in cloud cuckoo land.

There might be repayment a long way into the future but probably not even in the next 10 years.

So the issue is essentially one of psychology. And here it is a matter not of economics but of judgement. Mine is that on balance it would be better to keep the debt on the books. I don’t like using dodgy accounting as a way of changing policy. If the government wants to borrow more, let it make the case for doing so directly, rather than using an accounting wheeze.

So, to sum up the implications for policy: anything improving world trade competitiveness is potentially more valuable than is currently assumed; anything reducing domestically generated inflation is potentially more valuable than is currently assumed because it permits a more competitive currency level within the same inflation target; the bands around the inflation target should be widened, especially to take account of primary product driven inflation; it follows that policies that raise inflation such as raising fuel duties or VAT are more damaging to the economy than the gain that they produce from reducing the deficit; policies that damage competitiveness like the 50p tax are much more damaging than conventional analysis would point out; fiscal policy does not have to be as tight in public borrowing terms as it was planned to be in the 2010 June Budget, so the government does not have to recoup the deterioration in public borrowing from lack of growth by tightening fiscal policy; the financial markets would be much more willing to accept a less rapid deficit reduction if they were persuaded that there was a long run plan to bring down public spending as a share of GDP to somewhere between 30% and 40%; worldwide there is a case for more expansionary fiscal policy by a ‘coalition of the willing’; and dodgy accounting to write off government debt from the Bank of England’s balance sheet has no economic benefit.

Even taking the scope for improved policy into account, I think it would be foolish to believe that in the kind of world where we operate today that it will be easy to in the Western world to get back to the rates of growth that were achieved when there was less competition over the shares of the world’s economic cake. One of the consequences of the changed world is that we need to readjust our expectations.

**Conclusion**

We started this lecture by thanking the accountants for letting us use this hall. We went on to show how a different approach to understanding economic growth could help both with forecasting and with policy analysis and that using this approach might allow slightly higher GDP growth. We ended by condemning dodgy accounting as a way of fiddling the public finance figures – quite an appropriate ending for a speech given in this hall. Thank you very much for coming and for listening.
[7] This text is taken from Appendix 1, pages 122-3 of the IEA publication ‘Were 364 Economists All Wrong?’ edited by Philip Booth, Feb 2006.
[11] Harrod, R. (1933) International Economics (Cambridge : Cambridge University Press). This is the same Sir Roy Harrod who examined Sir Donald MacDougall for his degree and whose son Dominic Harrod was the BBC’s economics correspondent for most of the 1960s to early 1990s and who interviewed Donald MacDougall (and indeed me) many times.