INVESTMENT RESEARCH

Crunch Time For Policymakers

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Lord Nick Macpherson

in conversation with

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Nick Macpherson

Lord Macpherson is a former Permanent Secretary to the Treasury (2005-2016). He served under three different Chancellors of the Exchequer and was created Baron Macpherson of Earl's Court in Prime Minister David Cameron's resignation Honours list as a crossbench peer. He is a visiting Professor at King's College, London. Lord Macpherson is also Chairman of Hoare & Co and the Scottish American Investment Trust plc.

Introduction

As an outside observer or analyst it is easy to fall into the trap of becoming too abstract and forgetting that policies and actions are formed by individuals who are themselves influenced both by events unfolding around them and their previous experience. Equally, commentators are quick to criticise with the benefit of hindsight often in a manner which seems more akin to a scapegoating polemic rather than an attempt to provide helpful guidance. It is rare to get an insight from those who have actually participated in the decision-making process during times of extreme stress. This helps understand better the context of how we got to where we are, and hence what we might expect from here.

We are very fortunate here to be able to enter into a conversation with Lord Macpherson. Nick Macpherson has held the most senior positions in government, but as importantly, he was a key player in guiding policy through the global financial crisis (GFC) and helping to ensure that the crisis did not spiral downwards to precipitate a rerun of the depression of the 1930s. His background as an economist and this experience in government makes him ideally placed to provide insight as the UK and global economies arguably face equally deep issues which will require serious policy decisions to be made. It is also highly likely that the policy debates and political constraints apply not just to the UK and hence the insights gained from this dialogue are equally relevant across the developed world.

A Dialogue with Nick Macpherson

Q. **As someone who was at the centre of the successful policy response to the GFC how would you respond to the criticism that the policy that avoided the potential implosion of the financial system, mutated into something quite different?**

A. *Successful policy interventions invariably sow the seeds of the next policy failure. I was fully supportive of monetary easing, and unconventional interventions such as quantitative easing, in 2008-09. But central banks did not tighten when opportunities arose and became transfixed by narrow inflation targets, when – just as pre-2007 – wider asset price indicators began to tell a different story. Similarly, for all the talk of fiscal consolidation, most governments took advantage of an artificially low cost of funding to pursue more relaxed fiscal policies than were optimal. Then, faced with the Covid-inspired downturn in 2020, policymakers reached for the instruments which worked well in 2009. In one sense the speed of the 2020 interventions were admirable – they prevented mass unemployment. But when it became clear the economies were more robust than expected and would recover, "emergency measures" should have been withdrawn quickly. They weren't. And central banks are still playing catch up.*

Q. **At the time of the GFC, the policy response drew criticism from parts of the economics profession as likely to only elicit inflation. Before moving to talk about what we now face, is it helpful to remind ourselves of the dangers facing the world financial system in 2008?**

A. *Had the big banks collapsed in 2008, and we should not forget they came very close to doing so, the world would have faced a depression on an epic scale. I have no regrets about the scale of the interventions in 2008.*

Q. **It is arguable that there were a series of unusual circumstances that inhibited potential inflationary pressures that probably contributed to the sanguine attitudes on both fiscal and monetary policy. There seems now to be a common public view that the 'authorities/government' can fix any problem. With the levels of debt that have now been accumulated it feels like the can has finally**

reached the end of the road and that hard decisions are going to be required. Perhaps you could talk a little bit about how the decision-making process plays out in practice.

A. *Politics has become much more populist and less ideological. No problem is too big for the government to solve. And right-wing parties – whose philosophy 25 years ago was to leave it to the market - are far more inclined to intervene, whether through expansionary fiscal policy or propping up lame duck firms. Since the GFC, we have also seen mission creep among central banks. After all, it was the European Central Bank (ECB) which saved the Euro, when the sovereign debt crisis in Europe risked pulling it apart.*

The emergence of 24hour news and social media has certainly strengthened the hand of the "something must be done" tendency. However, one should not get too downhearted. Governments can and do take sensible long-term decisions, for example building Crossrail in London or reining in the cost of public service pensions. The pendulum also swings. The recent "fiscal event" in the UK is instructive. The market response to unfunded tax cuts is likely to make policy makers more cautious in the future. And the Leader of the Opposition here is singing the praises of sound money.

Q. That the inflation dog did not bark for a long time appeared to remove the constraints on both monetary and fiscal policy. Central banks seemed either terrified to be blamed for any economic malaise or remained concerned over the stability of the financial system well beyond the point where recapitalisation had been achieved. Governments if not explicitly accepting 'Modern Monetary Theory', certainly seemed to behave as if there was no cost to borrowing, nor some future day of reckoning.

A. *It has always been tempting to think of central bankers as philosopher kings, uninfluenced by public opinion. They may not have a political axe to grind. But they are human beings like you or me. The longer loose monetary policy continued, the more worried I think they became about how the public would react to higher interest rates. Many decision makers have only been in place during the low interest rate era, so long has it lasted. Understandably they don't want to be the people who cause financial hardship.*

My other theory about central banks is that they tend to follow each other. And so there's a tendency to avoid being the first mover. That has probably meant in the past that they have been too slow to loosen policy. This time round they have been too slow to tighten. It's a story of "too little, too late". As for finance ministries, there was a slight tendency to think the cost of borrowing would stay low forever: the last few weeks have been a big wake up call.

Q. **It is hard not to have a degree of sympathy for the central banks when the debate on the post GFC-world seemed to focus on the dangers of withdrawing monetary support, given the interpretation of how fiscal austerity unfolded. It appeared that the consensus moved to believing that fiscal restraint had been a mistake, and this should not be repeated by turning off the monetary taps too early. Certainly, financial markets showed signs of addiction every time there appeared to be a threat of the liquidity injections being removed.**

If this were not enough, we then had Covid. If Covid had not happened then perhaps the (Federal Reserve) Fed would not have doubled its balance sheet debt for a third time. Absent Covid, might tightening have then taken place? In other words, is some of the blame being attached to the central banks slightly unfair given the need to react to a global pandemic? The alternative argument is that the central banks have allowed their political independence to be compromised and the markets which loved this when it kept interest rates low is reacting badly to the new environment.

A. *In my view fiscal consolidation was necessary in 2010. But to quote Macbeth: “'If* it *were done* when 'tis *done, then 'twere well It were done quickly”. Gradualism didn't work: inevitably fatigue sets in as its political appeal diminished. Politicians did not need much excuse to change tack. Central banks became too obsessed with deflation; they also were overly focused on asset markets, tending to back off when markets took fright at the prospect of tightening.*

The longer interest rates were at the lower bound the more intertwined fiscal and monetary policy became. I didn't have a problem with the response to the pandemic. The lesson of 2008 was that the authorities had to cooperate and act quickly. By early 2021, however, it was clear the economy was recovering. We were no longer in an emergency, and so the emergency monetary response of March/April 2020 should have been withdrawn.

Q. **The absence of inflation, central banks as buyers of last resort and supine bond markets all seemed to have contributed to an environment where markets exerted little or no discipline on fiscal policy. Indeed, they also seemed to have become addicted to the sugar rush. We now have two potential divergences. Firstly, although it is muted by historic standards given the inflationary squeeze, bond markets have begun to react. Secondly, to the extent this continues, the implied social contract between government and the voting public becomes unsustainable, i.e. governments cannot fix everything.**

A. *For too long bond markets were impervious to the risk of inflation. An adjustment was inevitable, but the speed and timing has clearly taken many by surprise. It has been fascinating how interest rate expectations keep being revised upwards, with the UK clearly at the extreme end. The political trade-offs when it comes to fiscal policy are becoming clearer. Some countries will opt for maintaining higher social spending and will need to tax accordingly; others will prioritise lower taxes through spending cuts.*

The UK's experience is instructive: unfunded tax cuts have scared the market. I'm an optimist. In the end, politicians will have to have a grown-up conversation with their electorates about what is doable and what isn't. Central bankers are worried that their independence was compromised by (Quantative Easing) QE. They are not going to be prepared to fund growing deficits. But the transition to a new equilibrium will not be easy, as in the UK recently, where the Bank of England had to announce it would start buying government bonds only five days after it set out a plan to sell them.

Q. Difficult decisions always involve someone losing. Eventually they will have to be taken and it looks likely that there will be a lot of losers which will create a political backlash in its own right, but possibly exacerbated by political climate where hitherto some administrations have stated or implied that they can solve the electorate's problems. If you believe we face serious economic issues then could we see violent swings to the left or right?

A. *In my experience, electorates aren't stupid. If they feel their country is living beyond its means, they will tolerate a lot: look at Ireland in the euro crisis. In the UK, Alistair Darling and George Osborne did a good job after the financial crisis in explaining what had to be done. And although austerity gets a bad rap, remember the Conservative Party were re-elected with a majority in 2015. There will always be populists who will try to exploit difficult times. Some of them will get into power. But they too need to get re-elected. They have to navigate the markets. And so in the end common sense prevails but usually only after the markets' patience has been tested.*

Q. I have been concerned for some time that not enough attention was being paid to the potential misallocation of resources that would follow from an extended period where the pricing market signals have been suppressed. Perhaps this time the dangers may initially lie outside of the banking sector, given the increased supervision post GFC. However, it feels likely that the private debt arena may have stored up significant problems. As not only a trained economist, but someone who has been "in the room" at the most senior levels of

government, do you agree and how good a handle do you think the authorities have on the situation?

A. *You are right to be concerned. Regulators are not omniscient, and have a tendency to refight the last war, just when the terms of engagement are changing. They have rightly clamped down on banks. But squeeze one part of the balloon, and you encourage shadow activities. Central bankers have been making speeches about shadow banking for years. We are about to find out whether they have translated their words into actions, though I feel for them: recessions always generate ugly issues. We have got some taste recently in the UK for what could lie ahead. The liability-driven investment strategies threatened pension funds' solvency. The Bank of England had to step in to preserve financial stability by buying gilts. Clearly, there has been a regulatory failure but not one picked up by the normal stress tests.*

Q **Are interest rates going to return to historic norms in terms of a positive real yield? It takes some analytical gymnastics to avoid the conclusion that a recession is inevitable (and may have already begun). It seems to me the question is how deep and how long?**

A. *30 years in HM Treasury taught me that whenever someone says "this time it's different", you should be very worried indeed. I think there is going to be a recession. The Russian invasion of the Ukraine is creating a massive transfer of income from countries with a high propensity to consume to those with a low propensity to consume. The tightening of monetary policy will reinforce the trend.*

The recession will be deeper for those countries which lack macroeconomic credibility. I'm also worried about the steady increase in trade barriers across the globe. Commodity prices however can adjust quickly. The US should navigate this process better than most. And although China is struggling and things could get worse there, it continues to have massive potential. And so my bet's on a relatively short, but quite deep recession. The world could come out of it stronger if zombie entities go to the wall.

Q. **Where would you have the most concerns on a global basis? There are a number to choose from...**

A. *The Russian invasion of Ukraine is a reminder that politics can be more important than economics, and so we should continue to keep an eye on Taiwan. We should also keep an eye on the Chinese banks and property market. No economy can defy gravity. The Chinese leadership has not discovered the holy grail of steady non-inflationary growth. Mind you, I recall saying that to Alistair Darling in 2008, and 14 years on, Chinese GDP has pretty much doubled!*

Q. **Geopolitics may have a greater influence in the future with the economic dislocations exacerbating divisions. Do you agree and where would you focus your attention?**

A. *I've mentioned China. But I am also worried about the retreat to protectionism. Climate change is becoming a bigger issue. This is a world of flood and pestilence. That said, economies tend to grow. Humanity is ingenious. The Gladstonian liberal in me makes me still believe in progress.*

Q. **It is not just the low interest rate environment, but also the compression of spreads across both the corporate and government bond markets (e.g. Europe core vs periphery etc). It is hard to see how central banks can maintain either, given their balance sheets and the inflationary environment. So either spreads widen or central banks have another go at QE. Can you see a meaningful economy joining, if not the hyperinflation crowd, at the least the seriously compromised default candidate one?**

A. *We are clearly heading for trouble in the corporate bond market. Companies with weak balance sheets will be found out. We are due for some Schumpeterian creative destruction which will carry a big human cost but which may be good for the long term health of economies. Generally, sophisticated economies with their own exchange rates should be able to navigate what lies ahead though recent events in the UK are a reminder that you can't defy gravity.*

The eurozone remains an imponderable. But whenever the markets have posed the question of whether Germany really stands behind the eurozone, the answer is always the same: Germany has invested so much in the euro that it will always go a little further on integration to support the periphery.

Q. **With your background it is hard to resist asking for your opinions on the specific UK outlook, although I would understand if you did not wish to comment.**

A. *I've been disappointed by recent events, which perhaps reflects a little naivete on the part of some of the actors. My advice to successive governments was that sterling has long since stopped being a reserve currency. You cannot behave like the USA. But so long as policy does not get too far out of sync with medium sized nations like Germany, France and Italy, you can get away with a lot.*

Britain is now seen as an outlier and we are paying the price. The rise in the 30 year bond yields from 2.9 per cent to 5.0 per cent was extraordinary by any standards. The Bank of England has managed to reduce the yield at the long end through intervention, which is supposed to be temporary. But what happens when they return to selling gilts? Sadly, the

wound is entirely self-inflicted. I'm confident that the PM and Chancellor will learn the lesson. If they don't, they will be replaced by people who do.

Q. **On the assumption that the days of cheap debt are over and that a recession is coming, the UK will again face the decision of the balance between cutting expenditure and raising taxes. With a general election coming on the horizon, what do you expect over the next couple of years? What the government do and what are they likely to do? I assume this will be conditioned by a desire not to reverse the recent tax cuts, but there do appear limited options.**

A. *In the short run, I think the government will try to regain credibility by focusing on spending cuts. But the problem here is that it is not sustainable to cut public sector wages year after year. The poor have taken a big hit over the last decade, and so cutting their benefits is unlikely to make the government popular. The National Health Service is under huge pressure. Demographic pressures are increasing. And so the government will be hard pressed to set out a credible plan.*

That will take them back to tax where there will be pressure to delay the tax cuts. But to have to retreat on tax when the Prime Minister has made it central to her growth strategy would be humiliating. I would expect much greater focus on the Opposition's tax plans. The Labour Party is likely to restore the top rate of tax to 50 per cent. But I am confident that a Sir Keir Starmer government would be more like New Labour than the Labour governments of the 1945-79 period. They will want to keep marginal tax rates competitive.

Investment Implications

Likely exacerbated by some technical factors, the markets have initially taken an extreme reaction to the recent fiscal policy moves by the new UK Prime Minister and Chancellor of the Exchequer. It seems obvious that these budgetary measures were the fulfilment of the promises made to the Conservative Party membership during the recent leadership election. The visceral response does though seem somewhat of an over-reaction. As Lord Macpherson points out, there is safety in numbers when executing policy, at least in the short-run. One needs not to have watched too many David Attenborough nature programmes to see how predators pick off those that stray from the herd.

However, whatever the possible policy mistakes in the UK, the issues facing the UK are not particularly distinguishable from the rest of the world. Principal amongst these remains the level of indebtedness and the associated issue of debt service in a world where lenders demand a real return. This temptation to try and inflate away the debt overhang has been discussed before, the main question being how long it takes lenders to wake up to what is happening to the real purchasing power value of their asset.

Notwithstanding the issues that face the world, there was a recurrent reassuring tone to Lord Macpherson's comments in that whilst policy makers do tend to fight previous battles, this progressively changes and current issues do in the end get addressed. The main point here is that the electorate and markets eventually provide binding constraints on actions. The only caveat is that on very rare occasions, such are the economic stresses that these binding constraints can be broken by political extremism.

Whilst this remains unlikely in the developed economies, we do need to remain vigilant. The election of an extremist government and the accompanying potential to fracture deeply embedded financial structures may be what is often termed a tail event (that is, very unlikely) but it is one with severe implications. If social unrest rises sharply as economic conditions deteriorate, then so too does the possibility of such a tail event occurring. Markets will react to this change in probability, even if ultimately the event does not occur.

Whilst the innate ability to adapt and recover is reassuring, the context needs to be

remembered. It is a statement about ultimate rationality and human ingenuity rather than a suggestion that there is anything other than a rough road ahead. It is explicitly noted that there are going to be bankruptcies and a resetting of funding costs and availability.

Arguably asset markets are not, even now, attuned to this. The periodic rallies we have seen are born of a hope that we might be able to return to a low interest rate environment, supported by central bank intervention. The reality is that the return of a low interest rate environment is conditional on falling inflation and this is not likely without some kind of catharsis occurring first. It really does take a significant level of mental agility to create an analytical framework which obeys the fundamental laws of economics, but still allows a recession to be avoided.

In my view the only question on recession is how deep and how long will it be? Here are a few observations on that question.

Firstly, the UK now has an extremely competitive exchange rate, which does suggest meaningful benefits to the current account deficit, both in terms of foreign remittances and the visible trade balance. However, the UK has tended to be a structurally inflationary economy and the probability therefore is that these advantages will eventually be eroded. It also has to be remembered that whilst the public focus is on the sterling-dollar exchange rate, much of the depreciation is the result of dollar strength. For example, the yen has also suffered a torrid time against the dollar, as has (to a lesser extent) the euro.

These currency moves carry important investment implications. From a US perspective the elevated level of the dollar suggests we should expect a ballooning trade deficit in the next 12-18 months, which is liable to puncture some of the current exuberance associated with the greenback. On the other hand, the current level of the dollar also means that many US corporates will be licking their lips at potential overseas acquisitions. In terms of targets, the UK remains the market with a wide range of potential candidates where political interference is least likely. Hence one can see potential transactions across the board notwithstanding the less than supportive and deteriorating economic environment.

The flip side of the future ballooning US current deficit is that exporters to the US will

derive huge benefits. The most obvious beneficiary is Japan, which has some industrial sectors with world leadership which will be further bolstered by a ferociously competitive currency. The same applies to a wide range of other countries. The important question to which we don't know the answer is whether the deteriorating US trade balance will stimulate ever increasing protectionist sentiment.

Whilst the economic outlook is decidedly gloomy for the next few years, to take Lord Macpherson's point, we should not underestimate human ingenuity and the ability to recover. Whilst we need to be patient to see real investment value appear, the expectation is that we will see outstanding opportunities and there is every reason to think that some will appear in the currently least loved jurisdictions of the UK and Japan.

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Sandy Nairn is the manager of the Global Opportunities Trust plc, a self-managed global equity investment trust, and an experienced professional investor and author of three original books about investment. He has won multiple performance awards for the management of global equity portfolios.

Sandy was a founder and CEO of the independent investment boutique Edinburgh Partners in 2003. It was subsequently acquired by Franklin Templeton Investments in 2018, since when he has been Chairman of the Templeton Global Equity Group. Before founding Edinburgh Partners, he was Chief Investment Officer of Scottish Widows Investment Partnership, from 2000 to 2003, and Executive Vice President and Director of Global Equity Research at Templeton Investment Management, from 1990 to 2000.

In 2001 he published a book entitled *Engines that Move Markets: Technology Investing from Railroads to the Internet and Beyond*. In 2012 he co-authored, with Jonathan Davis, *Templeton's Way With Money* and in 2021 published *The End of the Everything Bubble: Why $75 trillion of investor wealth is in mortal jeopardy*, warning investors about an imminent severe decline in both stock and bond markets.

Sandy Nairn graduated from the University of Strathclyde in 1982 and in 1985 was awarded a PhD in Economics from the University of Strathclyde/Scottish Business School and has been a CFA charterholder since 1992. In 2020 he was elected a Fellow of the Royal Society of Edinburgh.

Important

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