

Q&A with Robert Kaplan and Lord Mervyn King



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Robert Kaplan:

Lord King thank you for being here. We really appreciate it. I will start with this, why did you become a central banker?

Lord Mervyn King:

By accident. I was an academic and I had taught in the states. I went back to London to the London School of Economics and I was asked to be a nonexecutive director of the Bank of England, which is a part-time position and I took that on.

And after six months, the then-chief economist decided to leave and move on to something else. So, the governor at the time, Robin Leigh-Pemberton, had to appoint a successor and he said, "Oh, do I really have to have an economist?" He wasn't very enthusiastic about it, and in light of subsequent events, you can see why.

But he was told he had to have one. So, he then thought very hard about it. At the Bank, there was a family sports day once a year and as a nonexecutive director, I had been invited to play in the governor's tennis match. And it was the best performance I had ever put on court to that date and indeed I regret to say, subsequently.

I hit the ball really hard and the ground shots went in. So, he was so impressed and he knew I could play cricket as well, so he told me if he had to have an economist, he wanted one who could play cricket and tennis. So, that's how I was offered the job. I had no intention of staying. I took it for two to three years with every intention of going back to academic life, but each time I tried to go back, something happened.

The first time we were forced out of the

exchange rate mechanism and I came up with the idea of inflation targeting, which we introduced at the beginning of 1993. And then I was about to leave again when the Bank of England was made independent by the incoming Labour government in 1997. So, I had to stay on to make that work.

Robert Kaplan:

Independence in that context meant what?

Lord Mervyn King:

It meant deciding interest rates. Up until that point, the level of interest rates had been decided by the Chancellor of the Exchequer and, in fact, we didn't even have regular meetings. You could sit in your office in the morning and get a telephone call saying that the Chancellor would like to discuss interest rates after lunch.

And so the financial markets had no idea when interest rates could change. They could change at any moment on any day, except of course when there was an election or there was some political event where it would be inconvenient to change interest rates.

That was completely altered in 1997, so much so that when Tony Blair stood down as the prime minister, it so happened that his announcement that he was standing down as the prime minister coincided to the very minute with an announcement that we were raising interest rates. That could never have happened under the previous regime.

Then I was asked to be governor so I had to stay on for that. Then I was going to leave after my first term, but we were bang in the middle of the financial crisis. But come 2013,

it would have needed an act of parliament to change the maximum length of a term, and that was too much for anyone. So, I was able to, at last, leave.

Robert Kaplan:

What's the importance of a central bank being independent? We are having a lot of conversations in this country about central bank independence. Why is it important?

Lord Mervyn King:

When we were made independent, it was not so long after the two decades of very high and volatile inflation of the '70s and '80s. Even here in the states, inflation reached 13.5 percent. In the U.K., it reached 27 percent, but it was all over the place and that led to volatility, not just of inflation, but of output and employment, too.

So, we were very keen to get away from that. And the way to achieve it was a combination of taking the decision on interest rates away from political influence, giving it to a central bank that genuinely had independence, and secondly, introducing an inflation target, either overtly or implicitly, in which the central bank would bring inflation gradually back to the target. And everyone knew that, so expectations of what would happen in the future were anchored to confidence in how the central bank would behave and I think that was very important.

What is fascinating today of course is that at the very moment when central banks are keeping interest rates very low, the politicians around the world are complaining that they are too low. This is the reverse of what

we had assumed would be the case. We now face the risk that if we abandon independence of central banks, we will throw out the baby with the bath water, and another decade on, we will find ourselves with high inflation again and then wonder how can we get it back.

And of course one thing we learned about inflation was that once you let inflation rise to a higher level, it's very costly to bring it back. You need a deep recession to bring expectations of inflation right down again.

Robert Kaplan:

You were the governor during the lead-up to the crisis and during the crisis. What are the key lessons you learned in the aftermath of the crisis?

Lord Mervyn King:

There are many of them I think. The first and biggest, and the one I talk about in my book, is that I think having created this remarkable period of stability of inflation and output, we rather got carried away and forgot the basic rule, which is you can never forecast the future. The future is inherently very uncertain and, therefore, you needed a system that can be resilient.

There is no point blaming anyone for this, but I think that what happened around the world was that the evolution of China as a growing and dominant economy injecting a lot of savings into the world economy—the phrase that Ben Bernanke used was the savings glut—started to bring interest rates down, especially long-term real interest rates, and we should have realized that this was creating something that was wholly unsus-

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tainable. In a healthy economy, expected long-term real interest rates on 10-year inflation-protected securities ought to be somewhere in the, I don't know, 3–5 percent-a-year range.

You can't find any historical period where that really was not the case. Over 25 years, 10-year real interest rates started around 4 percent, and they came down to zero. That cannot be an equilibrium. I think economists allow themselves to be so obsessed with the models that they have created but instead of sitting back and saying there is something wrong here, they just carried on with the traditional view that if you don't see enough growth, you cut interest rates.

Central banks in the West were cutting interest rates to boost domestic spending, and we were generating current account deficits, trade deficits, which meant that we were borrowing from abroad on a scale that could not go on forever. And in the end, it didn't. Much of that borrowing was mediated through the banking system. So, it was the banking system that collapsed first. That's one lesson.

I think the other big lessons are that we took our eye off the ball of leverage in the banking system that grew very rapidly in a period of five years. Nothing went wrong in that period of five years, but we should have been more alert to the fact that it was creating serious problems.

I don't think we had thought through how we would operate the regime of lender of last resort. We assumed that what we had all read about in the textbooks was, if we had a crisis, the central bank would act as a lender of last resort, lending through the banking system. But it turned out the banking system was completely different from the banking system that was described in the textbooks. We can come back to that later.

I suppose the other lesson I learned is that when there is a crisis, politicians will do everything they can to avoid blame. And, therefore, central banks were in an exposed position, and that's when it's very important for a central bank to keep its nerve and not

get pushed into doing things, which a central bank shouldn't do, like take big credit risk with its balance sheet. Those are decisions which ought to be taken by elected officials.

If the central bank says, "Well, no one else is going to do it, so I will," the difficulty is that after the crisis has gone away, the politicians will say, "What was your authority for doing that?" And then they use this as an attack for cutting back the authority of the central bank. And you have seen some of that in the debate about Dodd-Frank.

Robert Kaplan:

In the aftermath of the crisis, there really wasn't much in the way of fiscal policy in the Western world and so central banks in the United States, the ECB and the Bank of England took extraordinary measures to support growth. Do you think that central banks went too far, did too much?

Lord Mervyn King:

No. I think that in late 2008/early 2009, what we saw was a collapse of confidence around the world, not just in the industrialized world where we had experienced the banking crisis. My opposite number in Brazil would telephone me and say, "Car sales collapsed in Brazil but we haven't got a banking crisis." In India, steel sales collapsed; they didn't have a banking crisis either. And it was a real genuine loss of confidence, and international trade started to fall even faster than it had in the 1930s. There was the prospect of another Great Depression.

So, I think central banks had to act pretty dramatically to head that off. The problem was pretty much over by late 2009. The banking crisis in my view ended in May 2009, when the Federal Reserve and the U.S. Treasury announced the stress test of the banks and said, "Well, either the banks themselves have to raise capital or we will put it in and take shares in return."

That ended the banking crisis. But I think after that, central banks probably made a mistake in thinking that the cause of weak

demand continued to be a Keynesian downturn. In my judgment, demand has been weak because people came to realize during the crisis that the level of domestic spending in our economies beforehand had been too high.

Before the crisis, central banks saw that our economies were facing a structural trade deficit. Well, that's a drag on total demand, and if you want to maintain stable inflation and stable employment, you have got to get total demand to run in line with supply.

If net trade is being a drag on demand, you have to boost domestic demand so that when you subtract the contribution from the trade deficit, total demand is equal to supply. And central banks were very successful in doing it. But of course, what they did was to achieve stability but in an unsustainable way because domestic demand can't run forever above the level of productive potential.

What the crisis did was to bring home to everyone that we all had been spending more than we could afford to in the long run. So people cut spending, and that gap had to be filled by something; export demand is the

obvious thing.

What the source of demand weakness wasn't, was a temporary headwind, which of course is the language that central banks have come to use to describe the difficulty of generating a recovery.

I think the big mistake that's been made is if you misdiagnose the problem and say that the weakness in demand is just a temporary headwind, whereas in fact, it's a permanent fall in demand, what you will end up doing is not just cutting rates and wait until you see a recovery and then getting back to normal again; you cut rates, that generates a little bit of a recovery, but that peters out because the fall in demand is permanent.

So, you have to cut again, and you end up keeping cutting rates until you get to zero. Once you are up to zero, then only an economist can really believe that negative interest rates are the way to generate the recovery.

I feel that's where we are. There are some very good economists who think that if only interest rates could be -5 percent then we would get a recovery. But of course, if you ask people if Janet Yellen were to announce that



interest rates—far from rising—would be at -5 percent for the next year, most people will say, “What the hell are these people in the Fed doing?” Nevertheless, the economics professionals would cheer and say “Fantastic, you have done the right thing, now we are bound to get a recovery.”

Robert Kaplan:

Changing gears somewhat, what’s going to happen now, in first the U.K. and then in Europe, in the aftermath of the Brexit vote? What do you think the impact of this will be, and you think more countries in Europe will follow?

Lord Mervyn King:

No, I think not. Let’s start with the European Union. The European Union, I think, faces two existential problems, and they are serious. One is the monetary union, where I don’t think it’s working. I think it has been a disaster, and I don’t think there is any real prospect of having rapid economic growth in the European Union while monetary union persists. And they have no answer to this at all.

The other is immigration, where the principle of the free movement of people within Europe was a fine principle when you were just thinking of people moving amongst a small number of Western European countries to other countries. But it came under pressure when the Eastern European members joined the European Union, and it has come under intolerable pressure when a million or more people want to come from outside the EU into the EU each year.

De facto the Schengen Area, where there is a passport-free travel zone within the European Union, has been abandoned. Those countries have been forced to put up controls and barriers to prevent illegal immigrants being shipped on from the first country they arrive at to somewhere else in the EU. I think they have no answer to these questions at all.

But what is not an existential problem for the EU is British membership. If you look at what happens in Italy or France in their upcoming elections, the people who vote for Five Star in Italy or Marine Le Pen in France, they don’t go home in the evening and say, “You know darling, I was very impressed by the vote in Britain, and I do wonder whether



we shouldn't sort of vote in a similar way here"; they vote according to domestic conditions in their own countries.

So, I don't think that Britain leaving the EU will actually have much impact on what happens in the rest of the EU. The EU, I think, has serious problems, but I don't think they are affected one way or another by the U.K. staying in it, which was precisely why the U.K. was actually not having a lot of influence on the rest of Europe.

Now, in terms of the U.K., I think the situation in some ways is relatively straightforward. The prime minister said, and this was a fairly obvious thing to do, that there will be a bill to repeal the European Communities Act of 1972, which is the act under which we joined the EU. And then immediately pass a short bill to translate all existing legislation that we adopted as a member of the EU directly into U.K. law so that parliament can take its time to decide which of the legislation we have adopted in recent years we want to keep, or to get rid of, or to have another domestic debate about. But it will be the U.K. parliament that decides that.

When it comes to trade, I think, it's a lot simpler than some people would suggest. I think there are three groups of countries that matter. The first are countries outside the EU, but with which the EU has a trade agreement. And we go to those countries and say, "Look, when we leave, why don't we just roll over the treaty we have got with you already by virtue of our membership with the EU and just carry it on?"

The second group of countries are countries again outside the EU, but with which the EU itself does not have a trade agreement, we go to them and say, "We would like to have a trade agreement; either we get one, in which case fine, we are better off, or we don't, in which case we have got the status quo again."

And the third is obviously the rest of the EU, where we will have to negotiate with them. But there is a good cop and bad cop routine here; the bad cop will be all the European institutions, people in Brussels; the good cop will be politicians around the rest

of Europe, including in Germany, once their elections next autumn are out of the way, and they will be very much influenced by the fact that the U.K. has a very large trade deficit.

Now, there are not many circumstances in which having a big trade deficit is a good idea, but it just so happens that negotiating a trade agreement is one of them.

Robert Kaplan:

There has been a lot of discussion in this country of late about Dodd-Frank bank regulation. We have been advocating here that small- and mid-sized banks should get substantial relief because they are not systemically risky.

But there has been even discussion or suggestion that maybe even on big banks there would be a change. What's your view on what's an appropriate way for us to think about bank regulation here, in the U.K. and in Europe?

Lord Mervyn King:

During and just after the crisis, it seemed to me pretty clear that what we had to do was to move to a point where the leverage of the banks was a lot lower than it had been before the crisis. And of course banks themselves were trying to reduce their leverage.

Going forward, I would like to see a relatively tough simple leverage ratio. But I think that what we have actually done in practice is try to ensure that if the same thing that happened in 2007-08 happened again, that every single detail of that is now closed off.

So, what we have done is to create a massively detailed set of regulations that would almost certainly be irrelevant for the next crisis, which inevitably will be rather different. I think the only way sensibly to regulate the banking system is not to burden it with such detail. In the U.K. and London, I am amazed now that when you talk to people in banks, they feel they can't do anything without taking the advice of their compliance officer. That is not the definition of healthy regulation. That's excessive detail.

One simple example: Several central

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banks now have to approve the chief executive and the chairman of a bank. That's fair enough. But then they also insist on approving a whole raft of people below that level before they can be appointed.

Well, if you have approved someone to be a chief executive of a bank, why don't you trust him or her to make the right decisions about the people they want to employ?

Robert Kaplan:

We've been calling for broader economic policy actions to support economic activity going forward. What types of policy options would you encourage other policymakers to be considering?

Lord Mervyn King:

I think there are three sorts of things that are important. First, greater flexibility in exchange rates to prevent the buildup of unsustainable trade surpluses and deficits. The weakness of the euro area is a problem not just for Europe but for the world economy. Second, on the supply side, maybe people will think more imaginatively about the kind of changes that will be made. They have got to be sensible ones. But tax reform is one, particularly in the area of savings and investments.

Education is another if we are going to deal with the concerns of people who feel they have been left behind by globalization. The jobs that they were brought up to do simply don't exist anymore—that's always going to be the case. But education and retraining is a fundamental part of dealing with this problem.

I am also very worried about the impact of the current level of interest rates on the viability of pension funds and insurance companies, and just as worried about young people deciding whether it's worth bothering to put aside money for pension provision. So, I think there is a whole range of things that can be done in this area.

And the third is, international cooperation, and this is going to be the hardest of all. I think the problem at present is that most

countries in the world could genuinely say today, "If only the rest of the world was growing normally, we would be fine, but since it isn't, we aren't," and so countries are tempted to say, "So, what can we do on our own to get out of this trap, push down the exchange rate?"

Well, that's clearly a zero-sum game. So, we've got to find some way of creating a positive-sum game at the level of the world. The IMF ought to be able to do it, but I worry that it's become so political because of its relationship with Europe that they would find it very hard to do.

Robert Kaplan:

What about infrastructure spending?

Lord Mervyn King:

Infrastructure spending is a good idea subject to some caveats. The first one is that some proposals amount to a sort of Keynesian injection of demand. The trouble is, we don't face Keynesian unemployment anymore. The unemployment rate is down to 5 percent. So, if you have infrastructure spending, it is going to crowd out some other form of spending.

What is the other form of spending we think is less deserving? That's not obvious by any means, and the second thing is that it really ought to be something which is financed by government because infrastructure spending such as turning JFK Airport into DFW is not going to be cheap, and is going to be quite difficult to finance privately, I think. These are projects we need to pursue and plan, but you can't just switch it on like that.

Robert Kaplan:

But if we could do private financing, would you welcome private-sector involvement? For example, a lot of these airports have been turned into shopping malls in effect. If we could find a way to use less government money—more private money—would you say that was good or bad?

Lord Mervyn King:

Well, there is still a problem. If the answer is, let's do lots of investment in infrastructure, it doesn't matter who is financing it, some other spending gets crowded out, and I only favor private-sector providers for genuinely private-sector projects.

What I am very unhappy about, is what's being done in the U.K. and elsewhere, called the Private Finance Initiative, in which the private sector finances a project and the public sector then runs it. What's bizarre about this, is that it's completely the wrong way around. The public sector can borrow money much more cheaply than the private sector and the private sector can run things better than the government. So, why don't we do it the right way around?

Robert Kaplan:

[One last question to wrap this up. What advice would you be giving to the Fed from here as we watch the next phase of the recovery unfold?](#)

Lord Mervyn King:

I think if I were to give advice, I think I would say, central banks should now make it very clear that they can't really provide any more support. We have to be on a path of gradually trying to remove the stimulus that we have given in recent years.

The hopes for recovery have to rely on other policymakers. There are a range of different policies but they need to be thought through very carefully. It's easy to say infrastructure is a good thing, and indeed, there is obviously bipartisan support for infrastructure spending, but as both Martin Feldstein and Larry Summers have pointed out in recent weeks, infrastructure spending should not be carried out simply in order to reduce unemployment even further below what may well be a natural rate of unemployment.

And it doesn't make sense to create artificial ways of financing infrastructure investment merely in order to keep debt off the public-sector balance sheet. If there is a good argument for infrastructure, then issue

government bonds to finance it.

The problem facing the public finances in the United States is not a short-term problem, it's a long-term problem. One thing I think can be explained to people and be understood and accepted, is that all our pension schemes need to be modified to acknowledge that we are living longer. As life expectancy goes up, we must share the benefits of that between working life and retirement.

So, the age at which we qualify for pension has to keep rising, and this should be built into our pension schemes, both private and social security.

That would be one way to make a big dent in the prospective future deficits that we face.