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Interview: William White

With

Claire Jones
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Interview: William White

Claire Jones speaks to William White about the lessons from history in getting out of the current crisis and the need for thinking more long term about the consequences of policymaking.

For the United States to get the fiscal stimulus to work, much of their debt will have to be held externally not internally. But this exacerbates the problem of global imbalances. Do you think in the medium term, China and other countries with massive holdings of US assets should be looking to diversify and if so what into?

It's inevitable that in time these central banks will be seeking to diversify,: to the degree that the estimated correlations imply that they would be reducing their risks, and to the degree that alternative assets were available. While it's not clear to what extent the current stock of reserves could be reallocated in the near term, I could foresee central banks perhaps acting at the margin, such that any increase in reserves might be invested in a more diversified manner. The problem with the diversification of existing reserves, still largely held in dollars, is that attempts to diversify could drive down the value of the dollar and then the value of the portfolio would take a big hit. This is an area where I think people are going to be pretty careful and reserve managers tend to be pretty careful people to begin with. They're not the biggest risk takers in the world. It's worth noting, however, that the private sector has got a lot more dollar-denominated assets than the public sector and so what they do is another question.

William White

Are there any lessons that you think we can take from history and apply now to try and get us out of the current mess?

The first lesson from history is that history repeats itself, not precisely but in broad terms. And I think going forward we should always be cogniscent of the fact that we've seen this thing many times before. There were broadly similar crises in 1825, 1874, 1907, 1929, and the list just goes on. Ken Rogoff's and Carmen Reinhart's recent paper[1] is brilliant in terms of bringing together the data and showing this. Others – particularly Barry Eichengreen and Michael Bordo[2] – have also documented that financial and economic crises seem in recent decades to have become both bigger and more frequent. The fact that we keep on allowing these crises to happen time after time strikes me as more than a bit strange. After all, crises are extremely costly – we're talking double-digit levels of GDP for a standard crisis – so they ought to be in the very forefront of central bankers' and regulators' minds. Looking at the historical evidence, it is hard not to come to the conclusion that there's really a fundamental and recurring problem of "procyclicality" that policymakers should try to deal with. That is, credit induced expansions drive confidence, asset prices and spending to levels that eventually prove unsustainable and the boom is inevitably followed by a costly bust. As to why this problem has not been adequately addressed to date, I've argued elsewhere that we suffer from three problems: the acceptance problem, the identification problem, and the will-to-act problem.[3]

The **acceptance** problem is that some people will have to change their paradigm about how the economic and financial world works; what is the usefulness of models that don't even allow for the possibility of crises and don't specify the dynamics that can lead to crises over time? Particularly in America, Keynesian economics has been applied using essentially a one-period model: you have a problem (too little demand) and then you have an obvious solution (stimulate demand). Continental Europeans, going back to the Austrians and the pre-war business cycle theorists, have tended to think about things more in a multi-period fashion. They tend to emphasize that there is a tradeoff if you fix today's problem only at the expense of making tomorrow's problem substantially worse. Keynes famously said "In the long run we are all dead". Less famously, von Mises countered with "the task of economics is to foretell the remoter (rather than the immediate) effects (of policy), and so allow us to avoid such acts as attempt to remedy a present ill by sowing the seeds of a much greater ill for the future". It's a completely different philosophy and approach, and deserves more attention than it has received in recent decades.

The **identification** problem deals with how to recognise when a problem is building up so that their can be a discretionary policy response, using either regulatory or monetary instruments. I think there are ways in which you can do it. Some of my former colleagues at the Bank for International Settlements have done quite a bit of work on this, including in a recent paper by Claudio Borio and Mathias Drehmann.[4] They find empirical evidence that some combination of very rapid growth in asset prices and credit increases are reasonable predictors of future problems in the banking system. However, it must still be admitted that policy makers face a lot of uncertainty in this regard and this constitutes a further impediment to discretionary action. Finally, there is the **will-to-act** problem. That is, even if policymakers can agree that there's a real problem building up, they might not have the courage to confront it. The use of discretionary instruments to lean against these credit cycles is very tough because the fundamental problem comes out of human nature. As long as the good times are rolling nobody asks the hard questions about where the money comes from. Firms, ratings agencies, supervisors and central banks all find it very hard to act in a discretionary manner. I'm not saying that it's impossible for them to act, after all there is now a willingness to lean against inflation, which didn't happen overnight. Eventually I think we'll be able to do the same thing with leaning against the credit excesses that lead to financial instability. Eventually people will be able to say: "it's excessive, we're raising interest rates."

A lot of central bankers seem to have the idea that while leaning against the wind might not be a bad idea, doing so with monetary policy might be asking one policy tool to do too much and that central bankers really need another tool. What do you think of that view?

Central bankers say that they can't lean against the wind of credit excesses because it might drive prices down below their target levels. The first thing I'd say is "so what?" What is the great disadvantage of prices dropping a little below target if the alternative is to just simply let the boom proceed unhampered until it turns into bust and prices fall much lower? There was a wonderful illustrative advertisement on Canadian television some years ago. A man is in a garage talking to a mechanic who is trying to sell him a very expensive lubricating oil. The advertisement finishes with the mechanic holding the bottle in his hand, against the background of a car engine that's been torn to pieces, saying: "Well you can pay me now, or you can pay me later." The leaning against the wind argument is sort of like that. You may lean against the credit wind and, as a result undershoot your price target a little bit, but it is not at all clear that there are likely to be big costs associated with this. Put more bluntly, If you're in a situation where the economy is booming, and it's primarily credit driven, it is wrong to think that there must be the threat of a serious deflation just because tighter monetary and credit conditions have caused prices to fall below target. What is far more dangerous is letting the boom rip and getting into a much more serious debt-deflation spiral afterwards.

But if you were using two tools wouldn't it be easier for the authorities to lean against the upswing of the credit cycle?

It would be better to have more tools. I have said for ages that we need a new macro financial stability framework that would have both macroprudential tools and monetary-policy tools in the toolbox (see the article in this volume). However, as just noted, given that a lot more work needs to be done on how precisely and in what sequence those tools might eventually be used, a consensus now seems to be building that it is better to begin with regulatory tools. Going beyond that, it might be best to have regulatory rules that ensure automatic, rules-based leaning against the wind. This might also help deal with both the identification and the will to act problems. There are various ways in which this could be done; the Spanish, for example, introduced the so-called "dynamic provisioning". They now believe that, while those provisioning requirements didn't serve to moderate the cycle that much, it did ensure a big build up of provisions prior to the bust taking place. The Spanish banks are now sitting on big piles of provisions that they can gradually run down as the bad loans materialise. Another recommendation that I have made – although it clearly needs more technical analysis – is that, going forward under Basel II, we might use Pillar I calculations to determine the capital that an individual bank should hold. This of course would be determined by the individual bank's risk profile. But then you'd gross up that capital requirement using some formula based on system-wide developments thought likely to be dangerous. Pillar 2 of Basel II would seem to provide the authority for such actions. Thus if the system as a whole was displaying tendencies that you thought dangerous, capital requirements for everybody would get grossed up by that factor. Preventive measures such as these could possibly moderate a credit induced upswing, and would certainly give banks better means to weather the downturn. In turn this would mitigate the tendency of the banking system to ration credit and deleverage, once the downturn starts, thereby aggravating what might already be a serious recession. Such measures then act to cut off one of the channels that leads to the downward spiral.

The Swiss National Bank, although not directly responsible for regulation, has been keen to promote the idea of bigger banks holding more capital because of their systemic importance. Is that something that should be considered for all systemically-important institutions or do you think it would distort behaviour by providing an incentive for banks to break off into smaller units?

If you've got these great big banks and they're a systemic threat, in principle the externalities should be internalised through higher capital ratios. But I guess if the public sector imposed such standards, then the reaction of the private institutions might be that maybe they shouldn't be so big. Now I don't think that's so obviously a bad idea. Actually one of my worries at the moment, and it goes back to a more general concern, is that the process of mergers and acquisitions that we've seen since the crisis began is leaving banks even bigger and more complex than they were to begin with. Moreover, as another variation on this theme, virtually all big banks are now essentially universal banks. How does this square with the concerns raised about such banks by those who brought in the Glass-Steagal Act. There is something that is not quite right here.

Does the fact that innovation is often at the root of bubbles compound the will-to-act problem that you have mentioned? It must be difficult to act given the problems in distinguishing between speculation and the impact of the innovation on economic fundamentals through gains in productivity?

Absolutely. Some people say innovative products should be licensed like pharmaceuticals. But Robert Merton has argued that for any financial product that gains any sort of traction in the marketplace, there are hundreds that just disappear. So if you had any form of licensing, you'd have to have a process to license all of them and this would be practically impossible. And 99% of them weren't going to go anywhere, anyway. Further, we know that new products often get us into trouble the first time around, but then they often come back a second time with perfectly fine results. Junk bonds are a good example: initially everybody said "terrible stuff", but now there are trillions of dollars' worth of junk bonds out there that people buy and they do so in full knowledge of the risks they run. Recognising that innovation is the lifeblood of the whole financial and economic system, I would not want to say that structured products and asset-backed securities are evidently weapons of mass destruction and that we have to get rid of them. Far from it. But what we do have to say is that we've learned a few lessons about how far you can push these instruments. I think one clear message is that many of them should never have been rated in the first place and , closely related, that model-based pricing is effectively impossible for many structured instruments. The essential problem is that we're out of the realm of risk and into the realm of uncertainty because of the need to make core assumptions about correlations within the package and redemption rates. Unfortunately, minor changes to these assumptions can then have massive implications for both pricing and ratings. Did the rating agencies recognise this when they got into this lucrative business? I am not sure. Presumably, someone will write a book about it some day. ❑

Notes

1. See Rogoff, K. and Reinhart, C. (2008). "The Aftermath of Financial Crises", *American Economic Review,* May 2009.
2. Eichengreen, B., Bordo, M., Klingebiel, D. and Martinez-Peria, M. (2001). "Is the Crisis Problem Growing More Severe?", *Economic Policy,* April 2001.
3. White, W. (2008). "Past financial crises, the current financial turmoil, and the need for a new macrofinancial stability framework", speech at the LSE Financial Markets Group and Deutsche Bank conference, 3 March 2008.
4. Borio, C. and Drehmann, M. (2008). "Towards an operational framework for financial stability: 'fuzzy' measurement and its consequences", 12th Annual Conference of the Central Bank of Chile, 6-7 November, Santiago, Chile.