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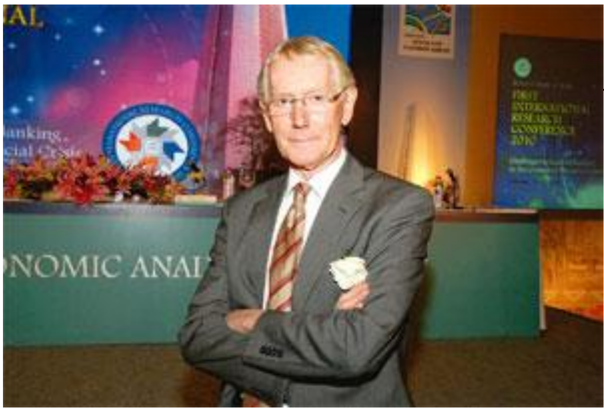
Mint sits down with economist William White, one of the few who warned about an impending financial crisis last decade, to discuss the future of central banking

William White would sympathize with the Hindu philosophy that human beings are stuck in an eternal cycle until they learn to liberate themselves. Economic policymaking has been stuck in its own eternal recurrence, too—a constant cycle of creating and then bursting bubbles— without learning anything. White has been "constantly amazed" at this phenomenon, the "amazing capacity" of some stimulus to "reignite the whole thing". He was convinced governments were stoking a bubble last decade; he thinks they're doing it again. "This time is exactly the same," he says.

Well, not everything is the same. When *Mint* caught up with him on the sidelines of the Reserve Bank of India's (RBI) first international research conference this month in Mumbai, it seemed that the mainstream of macroeconomics was finally catching up with him, too.

Before 2007, though, White was swimming against the tide. From his perch as the former chief economist at the Bank of International Settlements in Switzerland—the "central bankers' central bank"—he warned that central banks, his very clients, were dangerously creating too much credit. But up against US Federal Reserve chairman Alan Greenspan, the "Maestro" who had ensured years of stable growth, he sounded like a rabble-rouser. At the 2003 Fed symposium at Jackson Hole, Wyoming, White went against every grain of the zeitgeist, arguing that monetary policy could prick bubbles before they burst; Greenspan remained impassive.



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The mainstream was again in no mood to listen when, in April 2006, White wrote a paper—"Is Price Stability Enough?"—warning: "One hopes that it will not require a disorderly unwinding of current excesses to prove convincingly that we have indeed been on a dangerous path." He asked if central banks had been misled into thinking all was well because inflation was low.

White, who after his 40 years of experience in central banking is now with the Paris-based Organisation for Economic Co-operation and Development, explains why the Consumer Price Indices (CPI) central banks target don't tell much. Take housing: last decade, the rent prices that are reflected in CPI went down, because people were buying houses, not renting them; CPI ended up "pointing in the wrong direction". Does this mean central banks should forget targeting inflation? Conference participants were earlier concerned that this may be not just throwing out the baby with the bathwater, but even throwing out the bathtub.

White says inflation targeting can continue if amended. Asset prices, for instance, should "become an indicator along with a number of other indicators", broad ones such as credit growth, to "help guide monetary policy".

This sounds like a vindication of RBI's current "multiple indicator approach", where the bank looks at more than just inflation and assumes a broader mandate. At this conference, governor D. Subbarao noted RBI's other functions: Besides managing government debt, it regulates all banking institutions. In his own words, RBI is a "full-service central bank". That description resonates with the Canada-born White, in part because he served for 22 years at the Bank of Canada, another conservative central bank.

“I was struck when I was listening to (Subbarao)…it reminded me of the Bank of Canada” which also calls itself “a full-service central bank”.

“When (Subbarao) says that you are where you are, and this is the way we have to behave, he’s right.” And in the real world where India’s economic constraints demand more of RBI, there’s no point in arguing with practicalities. Still, at the back of his mind, is he concerned about what a central bank’s mandate means for its independence?

That’s the elephant in the room: A central bank trying to do too much will inevitably bring it into conflict with political forces, as is already happening in the US. “You can get drawn into politically sensitive issues: You bailed out this guy because he’s your friend, you go to the same golf club… This is the kinda thing that happens,” White says. That invites scrutiny on central banks such as RBI, where monetary and regulatory policy—setting interest rates and overseeing banks—are two legs of the same stool.

Still, central banks can’t ignore individual banks. “It’s very hard to distinguish between price stability and financial stability… It may not be just the monetary aspects that have implications for stability, but you have all this macroprudential stuff that matters.” Because it’s such a macro task, “my immediate reaction is that the overall responsibility of financial stability…(should be) with the central bank”.

At the same time, Ben Bernanke or Subbarao can’t be directly interfering with Citigroup’s capital ratio or ICICI Bank’s risk weights. White recommends a separate agency tasked with the “microprudential stuff”—the oversight on banks, financial institutions or markets. But “the macroprudential authority”—the central bank—“would have the right to say to the microprudential authority” that if, say, “credit is expanding too fast, etc…then I want all those risk weights to be multiplied by three or whatever”. That’s a neat separation of powers, an idea worth considering.

But will the mainstream consider it? Change is already afoot: In a staff note this month, the International Monetary Fund—a good barometer of the mainstream—says it’s rethinking the pre-crisis stance that monetary and regulatory policy shouldn’t be combined. It’s now becoming fashionable for analysts to wax eloquent about asset bubbles, when there wasn’t so much as a peep from them last decade. And with India and China—and even the Fed—considering a return to the status quo ante in the mere span of a month, perhaps there’s hope that we will finally be liberated from this endless cycle of bubbles.

To White, though, the world needs to go through a painful “process of adjustment”. Cheap credit last decade created “false demands… So, you have many industries in the advanced countries which are too big. And they are going to have to get smaller,” a process that “is not going to be easy”. If eternal recurrence itself is so amazing a phenomenon, breaking out to attain *nirvana* sounds too mythical.

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