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ANNEXURE

Time for a new analytical framework[1]

W I L L I A M W H I T E

I first met Steve about 30 or 35 years ago, and I have agreed with almost everything he has said over the course of the years. And this is particularly so over the last dozen years or so, when we agreed on the existence of a significant credit bubble likely to have equally significant negative consequences. So I can be brief by saying that I agree with him again. The global economy is in a big mess and, even though the analytical models do not show it, it is becoming increasingly accepted that excessive credit growth was somehow at the heart of this whole thing. The question now is what are we going to do to avoid such problems in the future?

There seems to be general agreement that regulation has a role to play, at least to judge by the Paulson Report (2008) or Lord Turner's Report (2009), or the report of the Delarosière Group. Where there does not seem to be agreement is on whether central banks have a role in leaning against these credit excesses. I have just two sets of comments to make on the issue. First, I want to make some technical points and then some more analytical ones.

At the technical level, the question is whether it is practically possible for monetary policy to "lean against the credit bubble". Those opposing this strategy have had a disconcerting tendency of referring to it as "leaning against asset prices". For them, this is a useful straw man because, when the question is posed this way, the inevitable next questions are: which asset price are you talking about, and what is the fundamental value of that asset? Of course, there are no answers to these questions, and so the proponents of "leaning" finish up by looking silly.

I think the question ought to be phrased differently. Is there any way you can lean against the credit bubble and its associated symptoms? If credit is the underlying problem, it manifests itself in various imbalances, which show up either as asset prices, unsustainable spending patterns as in the United States, or unsustainable investment patterns as we continue to witness in China. Can you lean against these credit driven imbalances? I think you can.

A lot of people contend that it is too difficult to know when you have a problem of excessive credit growth. I agree that is difficult. Yet, think of how we currently use estimates of the inflationary or deflationary "gap", the difference between aggregate demand and aggregate supply, for policy purposes. What do we currently know about

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[1] Comments by William White on the paper presented by Stephen S. Roach "The post-crisis fix: regulatory or monetary policy remedies?"

aggregate demand? The answer at the moment is very little, largely because of the influence on spending of balance sheet problems (like debt) of which we have had very limited experience in recent decades. Moreover, what precisely do

we know about aggregate supply? The answer once again is very little. Some people (including at the OECD) are talking about substantial changes in the level of potential, or perhaps even its growth rate. Yet, no one really knows how big these changes might be, especially when we take into account the need for overbuilt industries (like banking, construction and manufacturing in many countries) to be permanently wound down. Finally, we are now talking of reversing unprecedented policy easing measures, about whose impact we can have no real understanding given their uniqueness. Against such a backdrop of uncertainty concerning "conventional" monetary policy, would it really be so hard to spot a credit bubble?

Is it possible for monetary policy to clean up afterwards? We have frequently heard the argument that the econometric models say that it is possible. I will turn to the models in a moment, for what I think they are worth. However, a second argument that is often made is that the cleaning up process has always worked in the past. But there is a logical problem here. Suppose that it has always worked in the past, but the way in which it has worked implies that it has become less effective over time. In the end, stimulative monetary policy might then lose its effectiveness completely.

Consider this interpretation of events over the last 20 years or more. During the bust that followed the boom in asset prices in 1987, 1991, during 1997-98 and once again between 2001 and 2003, lower interest rates were used to stimulate spending . In each case, the lower interest rates led to another asset price boom of some sort, which in turn led to more spending and got the whole economy growing again. However, beneath all these successful interventions were the ever growing "headwinds" of debt, referred to as far back as the early 1990s by the then Federal Reserve Chairman Greenspan? In the end, it is that burden of debt — both on the part of the creditors who will not lend, and on the part of the debtors who no longer wish to borrow — that stops the interest rate driven growth cycle from working. So, the monetary policy strategy of lowering interest rates works for a while, but it does not work forever.

So to summarize, can you lean? I think you can. Can you clean up afterwards? I think what we are witnessing now is that you cannot, unless you spark another bubble. Indeed, this might well be what is going on at the moment. Paradoxically, however, we are seeing these effects largely in the Emerging Market Economies rather than in the Advanced Market Economies that were responsible for these problems in the first place.

The second broad set of points I wish to make pertain to the analytical framework that underlies policy decisions. If we are going to do what Steve wants us to do, and which I think we should do, we have to accept the idea that the economy often works quite differently from the way we have always been taught to believe it does. When you go through the academic literature, be it neo-Keynesian, neo Classical or DSGE models, they seem to me to provide almost no useful guidance for policy purposes. They begin with the assumption that the economy is self-stabilising and that economic agents are driven by rational expectations. These assumptions are totally incredible in the present circumstances. As for the kinds of models that the policymakers use, they

are not much better. Generally, they are essentially flow-based, one-period, models that do not have any stocks or credit driven imbalances in them. But, to my mind, stocks and credit driven imbalances have always been at the heart of those financial crises that have had significant effects on the real economy, including the current one.

Accordingly, we need to rethink the theoretical frameworks underlying our economic policies. First, we need to embellish our demand side economics by bringing in more of the "Economics of Keynes" as originally suggested by Axel Leijonhufvud. We also need to incorporate some of the insights from Austrian theory that relate credit expansion to supply side developments. At the moment, virtually no one is talking about the supply side. The most common view expressed during this crisis has been that we need to get demand back up again, regardless of the source of that demand. Surely, however, it is not optimal to have "cash for clunkers" programs when global car capacity far outstrips potential demand. In the United States, where Steve says household spending already accounts for 80 per cent of GDP, this would seem particularly evident. Further, holding

holding down the exchange rate in China to maintain jobs in export industries seems equally questionable, as do other measures to support manufacturing jobs in countries with huge trade surpluses. If it can be agreed that current global trade imbalances are "unsustainable", then all of these measures (in both debtor and creditor countries) are ultimately impeding needed supply side adjustments.

So we need a new analytical framework to be able to begin pondering these issues. This should lead to the conclusion that the policy challenges we have to face are different from the ones we thought we were facing a few years ago. To lean against the upswing of the credit cycle, we will have to contemplate the use of both monetary instruments and regulatory (macro prudential) instruments. Evidently, determining how best to do this will also pose big analytical challenges. And there will also be big institutional challenges as regulators, central banks and Treasuries struggle with "who does what" and how final decisions are best taken in this area. Perhaps

things have changed since I left the BIS, but my recollection is that there is plenty of scope for these different sets of public sector officials to work more closely than they currently do. And I think this applies at both the national and international levels.

So, my time is up. Let me then finish by repeating what I said at the beginning. I broadly agree with Stephen Roach!