INTERVIEW/ William White: Lessons from Greek debt crisis point to tougher rules and trimming debt

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The European Union needs a mechanism to set firmer fiscal rules that every member country must be obliged to obey, says Canadian economist William White, a former chief economist at the Bank for International Settlements (BIS) and current chairman of the Economic and Development Review Committee of the Organization for Economic Co-operation and Development (OECD).

White emphasizes that the lessons from the financial and fiscal crisis in Greece are clear: an exit strategy must outline a way to cut government expenditures, increase tax income and promote longer term growth through structural reform.

Following are excerpts of an interview with White by The Asahi Shimbun GLOBE:

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Question: What do you think of the bailout package put together for Greece?

Answer: Well, I think the package itself is perfectly satisfactory, in the sense that it's a big package. It addresses the problem of Greece's short-term financial requirements. It provides guarantees of Greek debt. In fact, I think the package was conceived as being big enough to reduce worries, not just about Greece, but about Spain and Portugal as well. So from that perspective, it's very hard to criticize the package, as such.

Two things can be said. One of them is that evidently the package does not include the idea of restructuring.

The second thing that I think worries me about the package was the way in which it had to be put together so quickly. Maybe this goes back to the first point, because the Europeans consciously did not include in the Maastricht Treaty (signed in 1992 to create the European Union) any

detailed provisions for this kind of package for crisis management. In part, it was because they felt at the time that even talking about crisis management would be an encouragement to bad behavior.

So here we are after all these years, the crisis is on us and they didn't have mechanisms to resolve it.

Q: Is it inevitable that the European Union is heading for a more fiscally consolidated union?

A: Yes, I do think so. I think that in order to make this thing work, what you need is a mechanism for setting firmer rules and for making sure that everybody obeys. And you also need, if that's for "crisis prevention," a clear understanding of what happens when things go wrong and you do have a crisis. So I think this means you're going to have to have, in a certain sense, more, clearer and stronger rules about a lot of things.

Now, I don't think it means "political union." All of these things are moving you in the direction of political union, but it doesn't necessarily imply political union. I think that the European community, ever since (World War II), has had all sorts of rules. You can have agreements among sovereign nations about how to "play the game," but they're still agreements between sovereign nations. But I think we need a further step.

Q: So, in that sense, to establish a European monetary fund is probably a good tool to realize what you're saying--like the IMF (International Monetary Fund)?

A: Yes, I think it is useful. There is a question here about the relationship. What precisely is the relationship between regional government grouping for both "crisis prevention" and "crisis management," and global groupings like the IMF and the World Bank and whatever? That's an issue that probably needs more attention, too.

But, on the face of it, if you have an entity like Europe, and (member countries) feel that they do wish to deal with internal problems internally--and really go external only if they have to, it's not self-evident that it's a silly thing to want to do. So this having a fund of some sort or burden-sharing arrangements, I think, is probably a good idea.

Even more important is getting some rules that would help you prevent these crises in the first place, and stick with them.

One other aspect of the issue has broader implications for the relationship between debtors and creditors. When you've got some combination of

lenders and borrowers, and the thing has gotten out of hand, that is the borrower has borrowed too much, we cannot forget that the lender willingly gave him the credit to allow him to do so. So it's very hard to say it's just the borrower's fault. This also applies at the global level when you start thinking about all the big creditor countries, like Japan, Germany and China, lending to the United States in particular. It is all very well to say that the Americans spent too much and behaved in an imprudent fashion but these creditor countries lent them the money to do so and on very favorable terms. So we're all in this together is basically what it comes down to.

In a "closed world" where everybody's asset is somebody else's liability, we're all in this together. That's the big lesson.

Q: I know about the "bubble system" of Japan lending money to the United States, but I think it was very difficult to raise the interest rate in Japan, given the stagnated Japanese economy. So what should we have done in that period? There was no policy choice except to decrease the interest rate.

A: You have been in this situation of very low interest rates for a long time, while other countries have only entered into it in the last two or three years. What I worry about is the medium-term and negative implications of all of these "easy money" policies, "easy fiscal" policies, and "short-term working policies."

All of these policies have short-term positive implications. Or to put it in your terms, to put it backward, if you had raised interest rates earlier in Japan it might have had negative implications. So short-term, we look at what we've done and we say--this is what we had to do.

But then the question becomes--what happens over time? When you look at fiscal policies, for example, we know instinctively that debt ratios cannot be allowed to rise forever. The gross debt ratio of the Japanese government is now 200 percent of GDP. Could it go to 300 percent, 400 percent or even 1,000 percent? We know this process cannot go on forever even if it has gone on without much trouble up until now.

What about policy interest rates? Keep them very, very low? OK, that stimulates demand, maybe. But on the other side, what you've got is a potential for bubbles and other negative consequences. Yesterday, (Bank of Japan) Governor Masaaki Shirakawa made the important point that big countries, like Japan, have to think about the implications of their policies for other countries. One clear implication of very low rates in Japan is that it has encouraged "carry-trades" into places like New Zealand, Australia and even back into the United States, causing big trouble. So your policies have "externalities" and can cause problems for other people.

But even domestically, and I worry about this in the United States as well, very low interest rates hold back structural reforms, and create both "zombie companies" and "zombie banks." And so, everything carries on without change. As a result, at the structural level, the economy is getting weaker and weaker and potential is going down and down, as happened in Japan in the last 10 or 15 years. And so, there's a big price to pay for all of this which you only see over time.

Now, the question becomes, when do you decide that you must exit from these policies? That is an enormously difficult thing to answer. I think one important factor really has to do with the financial markets, and when the financial markets should start pricing in a "risk premium," because they can see the medium-term implications of what you're doing. And the financial markets become a means of taking the "medium/long-term problem" and turning it into a "present problem." Because that's what the price of financial assets is. So that's what the markets do.

And in the Japanese case, we look at it and the likelihood of a "currency collapse," where people really lose money, is very, very small, because you've got lots of domestic savings and lots of external savings. So you've been able to run along like this for years and years.

But then I say to myself, what's the difference between Japan and the United States? The difference is that Japan has got an "external creditor" position of 50 percent of GDP, and the United States has got an "external debtor" position of 50 percent of GDP. Surely that makes a difference.

So, whereas you've been able to get away with this big government deficit for a long, long period of time, I think countries like the United States and the United Kingdom are inherently more exposed to the financial markets.

The only other point I can make with respect to "exit policies" is that Japan has had a lot more room for maneuver than many of these other countries have currently.

Nevertheless, Japan has also used up a lot of its room for maneuver. Nobody else has got both interest rates already at zero percent and government debts of 200 percent of GDP.

So you were initially in a much better situation. But now, you're gradually, I think, getting into more dangerous territory. That's how I see it, anyway.

Q: So in your view, despite the fact that the economy has not recovered to a great extent, we should probably raise taxes to cut the fiscal deficit?

A: My understanding is that there's significant room for maneuver in Japan. There are two sides to it. On one side--you have a debt problem. There are two ways you can deal with debt problems, assuming that we're not talking about "debt repudiation," which is what we're all trying to avoid.

You can try to close the deficit and reverse it going forward, which is some combination of expenditure cuts and tax increases. And my understanding is that tax levels in Japan are actually pretty low. So by the standards of all sorts of other countries, there's plenty of room.

The second thing you can do is you can try to "grow your way out of the problem." Now in Japan, as in South Korea and in many countries, actually there are a lot of structural reforms that one should be thinking about. And there, the OECD has made many recommendations over many years, mostly to do with the service industry--the "nontradable" goods industries--pointing out in ways in which you can both increase the number of workers and increase the efficiency of workers.

And on that front, one of the big things going forward, and I know this is a deep cultural thing, is the issue of women in the work force. There is an enormous potential for economic growth there that in Japan and in South Korea is very much underutilized.

So, if you can find structural ways to get the potential rate of growth of the economy to increase, well then the burden of debt and of debt service become less. As you go forward, I think you should be thinking in terms of both the fiscal framework itself and also thinking actively about ways to change how the Japanese economy functions to make it more efficient.

And, while I can't remember the exact numbers for productivity in the service sector in Japan, the level of productivity is actually very low by international standards. Now, it has to be noted that these societies, Japan and South Korea, taught everybody else huge lessons about manufacturing and more efficient manufacturing. And so, we're talking about people who are inherently capable. So it is surprising when you look at the "nontradable goods" side, that these countries remain so far behind. If you could get that added potential to increase the growth rate of the economy, then the burden of the debt obviously becomes smaller. So, you've got to be thinking in those sorts of terms.

Q: What do you think of the BOJ's new policy to encourage the lower interest rate to commercial banks, which will also encourage designated growth industries?

A: I think in the modern world, one has to be very careful about industrial policies, where the government chooses what's going to be good and what's not going to be good.

However, it must be noted that Japanese banks have really been so conservative for so long that the credit officers, in many instances, really don't know how to distinguish between "good credit" and "bad credit." Moreover, they don't have anything like a risk-taking culture because it's just been too many years and has had too many bad results.

So you need in some of these areas, lenders to do something that they're not used to. There's a kind of a "market failure" here that the government is trying to fill, and that's perfect normal and good, too. But, if you are going to say there's a "market failure," then you still have to hope that, at least in terms of the "broad designations" of favorite industries, the government is making the right choices.

Furthermore, if the emphasis is going to continue to be on somehow supporting lending to the "traded goods sector," this is not the right way to go.

Q: Back to the global economy. It seems to me that the financial crisis has moved into a sovereign debt crisis. If the crisis causes more downgrading of debt rating, it could force more governments to adapt policies of fiscal retrenchment. Do you think we should endure certain periods of stagnation in order to avoid another bubble or more dangerous things over the long term?

A: Well, I think at the very least, for many of these countries they should have an increasingly clear plan of how they intend to proceed to reduce worries about the unsustainability of debt. And other countries, the same as Japan, should be focusing on a number of things.

One is a clear plan in terms of cutting expenditures and increasing taxes, not necessarily today, but when conditions begin to improve. Another is steps to deregulate their economies, labor markets, product markets, more efficient provision of health and education. And, if you can get the potential growth up, then of course it makes it an awful lot easier to sustain these debt burdens. And that's what I think people should be doing.

So that's not saying it is necessary to exit today. But it's saying provide a plan for exit for tomorrow that, together with these supply side changes, will give people confidence and give you more time to continue with the stimulus provided by Keynesian policies. But absent any kind of plan, the markets are likely to get more panicky.

Q: If policy interest rates and fiscal expansion continues in the major countries, what will happen next? Will inflation finally come? Or, serious deflation?

A: Well, you have to remember that for most of these big countries, they've got big deficits. So what that means is the debt levels each year are going up pretty rapidly. Unlike Japan, a lot of these countries have got big external deficits to go with the internal deficits. So their "room for maneuver," or the time that they've got before the markets react badly, is clearly going to be much shorter. On the one hand, following the retrenchment policies suggested above could for a time intensify deflationary dangers. On the other hand, if countries do not undertake structural change and just keep applying fiscal stimulus and very low interest rates, I think what will happen is there will be a crisis, a still bigger crisis, in which the interest rates will move up sharply.

The worst alternative is you get a return to very significant inflation that will sort of eat away at these debts. But the problem, as we know from looking at Latin America and other places, is that if you start to use inflation to eat away the debts, it's only "unexpected inflation" that does it and this could easily get out of hand. That's a very dangerous possibility, but it is a possibility.

So, there's a chance for progress here and for getting out of the current set of dangerous circumstances, if we do collectively follow the right policies. But it's not self-evident that that's going to happen, frankly. And then you have these other less attractive alternatives.