Ultra easy money today, hard times tomorrow

Maximilian Walsh

When Bill White was the chief economist at the Bank of International Settlements (BIS) before he retired in 2008, he was referred to by the US Federal Reserve delegation with heavy irony as Merry Sunshine.

He was regarded as a dismal gadfly who had the temerity to challenge the banking orthodoxy of the day, as defined by then Fed chairman Alan Greenspan, known, without irony, as The Maestro.

The Swiss-based BIS is the world's most exclusive club with a membership of 55 central bankers, including Australia's Glenn Stevens. They meet every two months to discuss central bank concerns.

From 1987 to 2006, Greenspan pretty well set the global agenda for monetary policy. The central tenet of his approach was that official interest rates could be significantly lower than the historical experience because inflation was no longer the risk it had been. The gospel of easy monetary policy was spread far and wide on the wings of globalisation and deregulation.

Despite the dismissive treatment, White continued to issue warnings about the adverse economic implications of easy credit until he was proved, in a painful but convincing fashion, to be correct.

The Federal Reserve Bank of Dallas, which is chaired by Richard Fisher, has published Bill White's latest paper: "Ultra Easy Monetary Policy and the Law of Unintended Consequences". It doesn't make for comfortable reading, but White's record means it deserves attention.

His opening sentence sets the scene: "The central banks of the advanced market economies (AMEs) have embarked upon one of the greatest economic experiments of all time – ultra easy monetary policy."

It's White's contention that the immediate response to the global recession of 2009 of lowering interest rates to stimulate demand was understandable and correct.

However, it has only "bought time" for other, non-monetary measures, to be brought to bear.

This observation has relevance to Australia where successive rate cuts are having a smaller impact on demand than anticipated.

There are, White says, limits to how much central banks can do without the risk of long-term consequences such as hyperinflation and deflation overwhelming the short-term benefits that have been achieved.

White is no fan of traditional economic modelling, arguing that the economy should be treated as a complex, adaptive system. Such systems, built up as a result of cumulative processes, can have highly unpredictable dynamics and show significant non-linearities.

He notes: "The insights of George Soros, reflecting decades of active market participation, are of a similar nature."

White makes the important point that John Maynard Keynes focused on how to extract the economy from a hole. The Austrian school spearheaded by Ludwig von Mises and Friedrich Hayek, on the other hand, focused on why the economy found itself in such a hole and how to avoid repeating such an outcome.

In Australia we see successive rate cuts are having a smaller impact on demand than anticipated.

On this latter point, White argues that cheap credit leads to wholesale mal-investment such as we saw in the housing bubbles in different economies. The US bubble, dismissed as a problem by Greenspan, corrupted financial markets and impoverished millions.

White sees ultra easy monetary policy as being particularly pernicious for the financial sector, as threatening the health of financial institutions and the functioning of financial markets, which are increasingly intertwined. This provides a negative feedback loop to threaten growth.

Further, White says, such monetary policies threaten the "independence" of central banks and can encourage imprudent behaviour on behalf of governments. In effect, easy monetary policies can lead to "moral hazard on a grand scale". Once on such a path, "exit" becomes extremely difficult.

Also, monetary policy has distributional effects, favouring debtors over creditors and the senior management of banks in particular. White's "solution" is a normalising of interest rates, which would, among other consequences, have the effect of increasing the cost of servicing high levels of public debt. He concedes that Martin Wolf of the *Financial Times*, Richard Koo of Nomura and others are "undoubtedly right" in suggesting that a debt-driven private sector collapse should normally be offset by public sector stimulus.

"What cannot be forgotten, however," he says, "is the suddenness with which market confidence can be lost."

What is obvious as you read White's exposition of how easy money has fashioned the contemporary economy is that exiting from a period of ultra easy monetary policy will not be easy.

Central banks using the traditional models of output gaps will be reluctant to raise rates if growth appears sub-normal.

If short-term rates are moved up, it's quite possible that long-term rates will be under pressure and could even spike upwards, threatening financial stability.

You can bet governments will resist higher rates. The idea that rates must be cut to stimulate an under-performing economy has become embedded in the political psyche. Higher interest rates would hit the public debt-servicing bill and the annual budget.

And as White writes: "Further on the basis of previous experience the entire financial community (with its formidable capacity for public communication and private lobbying) will oppose any tightening of policy as too dangerous."

In addressing the issue of exiting from the ultra easy monetary regime that currently defines the global economy, Bill White has ventured where others have not been prepared to go. The absence of alternative scenarios to those canvassed by him underlines just what an open-ended economic experiment we are engaged in.

■ *Maximilian Walsh is deputy chairman of Dixon Advisory and a former editor and managing editor of The Australian Financial Review.*

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