

## Interview: William White

**William White tells Christopher Jeffery he is wary of placing too much reliance on the 'science' of monetary or regulatory policy. He believes economic stability will only be achieved by addressing the large imbalances in the world's economic and monetary systems.**

**How much responsibility do you think central bank monetary policies had in causing the financial crisis?**

It is the difference between 'the school of what is different' and 'the school of what is the same'. The 'school of what is different' was clearly in the ascendency just after the crisis broke. Supporters said the real problem was all these new instruments – the subprime loans, the collateralised debt obligations (CDOs) and the CDO-squareds. Financial innovation got us into the crisis and the bankers, who were prone to excessive greed. The regulators missed it all and they were also blamed. And there is a lot of truth in it. But then there is the 'school of what is the same' – you look back into the history of crises and see there were no derivatives and CDOs. There seems to be a much deeper set of root causes. The fact that these things happen all the time, and under enormously different regulatory and monetary regimes, indicates that there is something inherent in a capitalist system that creates the conditions for crisis.

I have a lot of sympathy with [economist Hyman] Minsky, who



William (Bill) White is chairman of the Economic and Development Review Committee at the Organisation for Economic Co-operation and Development in Paris. He speaks here solely in a personal capacity. Prior to his appointment in October 2009, he was economic adviser at the Bank for International Settlements (BIS) in Basel. White joined the BIS in June 1994 as manager in the Monetary and Economic Department and was named economic adviser and head of the Monetary and Economic Department in May 1995. White started his career at the Bank of England, where he was an economist from 1969–72 prior to 22 years at the Bank of Canada. He left the Bank of Canada in 1994, after holding a number of banking and research roles, ultimately becoming deputy governor in 1988.

**Do you blame central bankers?**

Central banks have got to take some responsibility for what's happened.

**But they would say they have stuck to their inflation targets, as required by their legal mandates?**

The analytical framework that people are using is not broad enough – it's not just a question of inflation arising from all of this, it's all these other imbalances in the economy that can cause huge amounts of trouble. For example, there was something odd about the downward trend in household savings in many countries, with the household saving rates in the US going to zero and in New Zealand to minus 8%. Driving down the savings rates like that was odd, to say the least.



*William White*

**Why was none of that reflected in the inflation figures?**

In 2007 and 2008, the stimulus worldwide was producing some significant inflationary pressures. Just as the crisis broke, the Fed was leaning vigorously against the downside and the European Central Bank (ECB) and a number of other central banks were still raising rates because inflation was rising dramatically under the influence of food and energy. The Fed used to take food and energy out of headline CPI, so it may have been less concern, but other people were really worried about it. So I think around 2007 and 2008, you could see all of these things building up. But beyond that we had a massive increase in infrastructure investment, a lot of which in retrospect, people say has been wasted. We had current account imbalances as the US was saving so little and the Chinese were saving so much.

When you turn to emerging market economies, we are also seeing some pretty odd stuff too. Investment ratios in China that were 40–45% pre-crisis have gone up to 50% post-crisis. This would never have happened if the interest rates hadn't been as low as they were. Then there are the imbalances in the financial sector – the massive run up in the leverage of many financial institutions, not least the big banks, to match the increased leverage on the household.

deleveraging you usually see in response to a crisis.

**Where are the problems building?**

If getting rid of all the problems that built up during the boom phase was an intention, this hasn't happened. One reason is because very easy monetary conditions have positively invited banks to evergreen loans. This has real implications. Banks with too low levels of capital don't want to lower it further. They have kept alive companies that are zombies. And these zombie companies are competing with the people that actually could make a positive contribution to growth – the zombies are dragging the living down into the grave with them. Research by Eric Rosengren, president of the Boston Fed, demonstrated those industries that had seen the worst performance in terms of reduced productivity growth in Japan were the same industries where evergreening was the most prominent. You're not getting, [Joe] Schumpeter's 'creative destruction'.

***Zombie companies are competing with the people that actually could make a positive contribution to growth – the zombies are dragging the living down into the grave with them***

**How do you view the ECB's position as banking supervisor over a robust banking sector?**

The ECB has got an excellent reputation in Europe. But it is caught in a logical conundrum. There is a need for a fiscal backup for recapitalisation of banks, if they need it. But at present the ECB is in the very difficult situation where it may be forced to announce banks have capital shortages, are insolvent or in danger of becoming insolvent, but it does not have a solution. Someone needs to have some capacity for resolution.

The approach at the moment is completely backward. There are two sets of issues; one of them is crisis management and the other is crisis prevention. Crisis prevention has to do with banking supervision and regulation, and that's what they're focusing on. But crisis management really has to do with deposit insurance and resolution. If banks are bankrupt they need to deal with it, but that is not happening. In a world where you didn't have a crisis to manage, it would be perfectly legitimate to start with crisis prevention. But we do still have an ongoing crisis and it needs to be dealt with.

**So despite the improvement in sovereign spreads, the situation in Europe is still precarious?**

I find it difficult to believe the problems are over. There are just too many flashpoints, particularly at the political level. Underlying economic problems still need to be resolved, not least of which is the question about the banking system. If a bank doesn't know whether

austerity measures have seen results that were greatly inferior to expectations. Now the IMF, notably [chief economist] Olivier Blanchard, has suggested fiscal multipliers are probably significantly higher than originally estimated, in part because interest rates are already at the zero lower bound – so they cannot go down to cushion the effect of fiscal restraint.

**In terms of ‘group think’, one of your papers stated Bill Poole, then a Federal Open Market Committee member, had never heard of many of the concerns raised by the BIS prior to the crisis. Did that surprise you?**

Poole said this in a paper he presented at the Reserve Bank of India. That was fascinating – nothing ever went back from the BIS to the Citadel!

**What do you think of using monetary policy to ‘lean’ against credit bubbles and how do macro-prudential tools fit in?**

Many respected economists are strongly of the opinion that you shouldn’t be leaning, that there should be other tools that should be used and, in fact, leaning gets in the way of the primary mandate: to target inflation. There is this whole macro-prudential toolkit that will save the day. But the new toolkit is just the old toolkit that we gave up in the 1960s and 1970s. When I did my PhD in Britain in the 1960s, they still had things like hire-purchase controls, which are basically loan-to-value ratios. Now people are talking in terms of variable-capital ratios and counter-cyclical capital ratios as part of Basel III and a whole host of other instruments.

**Where do you stand on the issue of ‘too big to fail’?**

If you think about the added requirements for big banks that are deemed too big to fail, solution number one is to give them added capital requirements to reduce the probability of their failing. But an alternative is to focus much more on reducing the economic costs associated with such a failure. How can a big bank be wound down in an orderly way? Huge efforts have gone into this, but there’s not an awful lot to show. The Financial Stability Board came out with a report to the G-20 this year that says there is inadequate national legislation to deal with these issues. Even the Liikanen, Vickers and Volcker efforts are being resisted tooth and nail by the industry. So again, there were some hopes but not huge amounts of progress – and this is five years after the whole thing started.

**Where should the regulatory focus be?**

It needs to be on the systemic character of the financial system. Has it grown too complex and too interdependent? Should it all be rolled back? There’s been very little on that. I’m not saying it should

in advance, knowing that most of the predicted crises never actually materialise, you're building a lot of costs into the system that you needn't have.

**Do you believe there is an increased scepticism about economic forecasting, given the failure of most models to predict the crisis?**

I would hope so. In 2008 most forecasters expected real growth in the advanced market economies of about +3.5% in 2009. In the event, it turned out to be around -3.5%. Since then, forecasters have routinely predicted faster growth that failed to materialise. The fundamental problem is that the analytical models used by most forecasters fail to recognise the importance of financial developments and the nature of credit cycles. Thus, they inevitably miss the development of 'booms' and 'busts'. Fortunately, looking forward, there seems to be a growing willingness to question conventional ways of thinking about how the economy really works. For example, the OECD has got a new project under way: 'new approaches to economic challenges', asking deep questions about what worked and what didn't work, and did we give good advice or not? But there's also something deep in the human psyche that wants to believe. So you had these huge forecasting errors and within six months respectable newspapers had the forecasts back on the front page again.

**Are policy-makers exerting more effort looking into minimising tail risks rather than seeking optimisation?**

Not really. Keynes once famously said that if economists could get themselves thought of as plain practical workmen like dentists that would be splendid. I would prefer to say that we should be like doctors; above all, do no harm. QE is a good example – it's a huge experiment on the spinal column of the entire global economic system and people seem to be quite at ease with it. This huge experiment being pursued in the US is all in a bid to get another half-a-percentage point off the unemployment rate. The proponents are saying, 'nothing has gone wrong so far'. But I would turn it around and say, 'well, the benefits are relatively modest when you compare it to the incredible uncertainty associated with where this unprecedented economic experiment might lead us'.

**You have described the international monetary system as a non-system. What do you mean?**

Systems are established because they provide collective benefits to the participants, and they also contain rules to prevent behaviour that in the end will destroy the system and the advantages it brings. After the breakdown of the Bretton Woods system, many thought that floating exchange rates and national policies directed to price stability would suffice to promote international trade and an efficient international

everyone tends to view other people's behaviour as unfair but never question their own behaviour. However, there is a further practical complication to take into account, in effect a massive market failure. Statements that countries should simply let their currencies float upwards, in response to monetary easing in core countries, ignore the fact that the theory of uncovered interest rate parity only applies over long time periods. Thus, when a currency starts to rise it is not the case that it is quickly seen as being overvalued and stops rising. Rather, a currency that is going up often gets driven much further by momentum trading. In this way, currencies can move a long way from natural equilibrium levels, imposing significant economic costs in turn. This does provide a justification for using non-market methods, like capital controls and the use of macro-prudential instruments, to respond. That said, the danger always remains that countries will use capital controls, not to avoid overvaluation, but to keep their currencies fundamentally undervalued. In cases of doubt, independent evaluations related to IMF surveillance are welcome, although the IMF's capacity to discipline creditors has always been a problem.

*The benefits [of QE] are relatively modest when you compare it to the incredible uncertainty associated with this unprecedented economic experiment on the backbone of the global economy; the monetary system*

#### **What do you make of the reactions to 'talk of tapering by the Fed'?**

QE is about a change in the proportion of the stock of debt – government debt or otherwise – in the hands of the private sector as opposed to the public sector. So if more of it is in the hands of the public sector then presumably interest rates will go down, because there's less of the stock for the private sector to absorb.

All Bernanke did was muse about the possibility of a reduction in the flow – several derivatives away from an actual reduction in the stock – and a number of non-US markets exhibited huge market declines. It's incredible. When I look at the initial effect of the taper talk, how far away it was from an actual reduction in the stock and how difficult Bernanke found it to explain that difference so that the market wouldn't panic, you realise this is truly experimental stuff.

#### **Do you think forward guidance has been helping or not?**

I have got a lot of doubts about forward guidance. It is something that has been around from time immemorial – in the sense that we all know that the long-term rate is a form of geometric average of the expected future short rates. So if you can actually convince people