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Q&A: Bill White on global monetary policy in an era of post-crisis politics

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Even a relatively limited fiscal stimulus by the Trump administration might give the Fed cover to tighten monetary policy, which in turn could lead to more overt political pressure on the central bank. This is the view of **William R. White**, a well-known critic of unconventional monetary policy. White is currently chairman of the Economic and Development Review Committee at the OECD in Paris, and was formerly chief economist and head of the Monetary and Economic Department at the Bank of International Settlements (BIS) in Basel.

Bill White spoke to Beat Siegenthaler of the UBS Knowledge Network in Zurich on Jan. 20.

Beat Siegenthaler: What is your expectation for US economic policies under President Trump, particularly on the fiscal side?

Bill White: President Trump has made a number of fiscal policy suggestions, some of them on infrastructure, others on corporate tax reform, as well as the so called 'border adjustment', basically a cross-border tax. All of these policies are plausible, certainly the infrastructure plans, which he has talked about a lot. But he will have to get congressional approval, which will not be easy given the deficit and debt implications and the traditional fiscal conservatism of the Republicans.

Trump also seems to be proposing tax incentives for the private sector to do a lot of the infrastructure projects. Solar energy might be a good example for such schemes where companies make investments because they get tax credits rather than because they make a profit. The tax credits can then be sold to the banks, though the tax credit market would have to grow very substantially if this was to matter on a macroeconomic scale. So this may or may not happen, and it certainly is not going to happen very quickly.

BS: What do you think about Ken Rogoff's view that the underlying political economy of deficits means that whenever a party, regardless whether conservative or not, has firm control of government, it has a powerful incentive to borrow to finance its priorities?

BW: I do expect there to be some deficit spending, but it may not be as great as people assume. The long-term fiscal position of the United States should worry fiscal conservatives and I think there will be ideological resistance to large-scale fiscal expansion. So it may be less and slower than many people anticipate.

The corporate tax reform is a different story. What Trump seems to propose is a much lower base rate, paid for by weeding out all the exemptions. And all you can say is good luck, because everyone benefiting from the exemptions is going to put up a heavy fight. So again, we see the direction in which the administration is proposing change, but there will be resistance to this change. I can see all sorts of reasons why the reality may be both less in magnitude and further away in time than the equity market seems to assume.

BS: Do you think the Federal Reserve's reaction function will become less cautious due to the projects of the new administration?

BW: Adding fiscal expansion on top of an economy more or less at full employment will increase inflationary pressures. This will give the Fed more grounds for saying that the time has come to further raise rates, and I dare say they will do so. Now, there's a problem of course. If you do get stimulus and you do get tighter interest rates as a consequence, the dollar will go up. And the Trump administration is very concerned about trade and wants the trade deficit to go down, but a strong dollar will work in exactly the opposite direction. So I wouldn't be at all surprised if the new administration were to exert more overt pressure on the Fed than we have become accustomed to in the past.

BS: If the new administration wanted to weaken the dollar, how could they go about that?

BW: The principal way that they can exert

"I wouldn't at all be surprised if the new US administration were to exert more overt pressure on the Fed"

influence is via Fed appointments. There are currently two vacancies on the board that Trump can fill. In addition, Chair Yellen's term expires early next year and Vice-Chair Fischer's term expires in mid-2018. So potentially there will be four positions to fill within about 18 months or so. But I have absolutely no idea who they might appoint. On the one hand, the conservative bias is towards ending this ultra-easy monetary policy as being something unusual and dangerous. But on the other hand, we also have the bias towards a lower dollar on the trade side.

BS: What about the balance sheet of the Fed where the usual conservative bias would be to reduce it as soon as possible?

BW: I think that if the Fed runs down the balance sheet it will be in the context of an attempt to tighten monetary policy. There has been a debate going on as to whether you should start with raising interest rates or whether you should start by reversing the increase in the size of the balance sheet. And what's come into the debate is the suggestion that there might be circumstances in the future when the Fed might want to sell Treasuries to raise term spreads or sell other assets to raise credit spreads – the very opposite of the unconventional measures used to date. But, if so, the Fed has to have such assets to sell. This argument would support not going back quickly to a much smaller balance sheet.

Everything is interconnected. If you get fiscal expansion, the Fed will tighten, interest rates will go up, and debt service charges will rise. And markets might start to worry about fiscal dominance, pushing rates up even more, with a risk of a disorderly outcome. We just don't know what could happen because ultra-easy monetary policy has generated so many imbalances out there. We just don't know what will happen when all of this gets reversed.

BS: How do you assess the European situation?

BW: There is a very large amount of non-performing loans out there, maybe something like a trillion euros, only about half of which are being provisioned for. Banks are worried about their future prospects and are thus less willing to lend. This is a problem that Europe faces, in addition to all the political problems. The ECB to some extent is the only game in town, and is thus overburdened. They are aware of this but don't see any alternative to simply carrying on. So the ECB seems committed to asset purchases for a significant period of time yet.

Can they ever get out of it? I don't see any reason why not, but just as discussed before, when you've been doing something unusual for a long period of time and then you stop doing it, there is a degree of uncertainty associated with what happens next which will make everybody very cautious.

BS: Do you think unconventional monetary policies have contributed to recent political developments in the US, the UK and elsewhere in Europe?

BW: Growing inequality of income and wealth in all of the advanced market economies has far more to do with changes in technology and with globalization than it does with monetary policy. Central banks may have contributed to the increase in asset prices, thus making the rich people owning these assets even richer. But it is a small part I think.

There is a much deeper question though on how financial crises lead to political disruption. It has been well-documented that such crises polarize society and that it's mostly the people on the right who come out of them ahead. Or maybe instead of using left and right, we should distinguish between inward-looking and outward-looking people. And it is the inward-looking people who seem to benefit most, the people who say, 'we have a problem, and foreigners, immigrants, globalization are to blame'. This has been very common in history and what we are seeing at the moment is not much different.

Many of these financial crises had their origins in excessive credit and excessive speculation and leverage. And central banks may have failed to control, or even contributed to the situation through easy money. If so, it would have been just another unintended consequence of unconventional monetary policy. No central bank anywhere would have thought five years ago that what they were doing might lead to more rather than less political instability.

BS: Moving over to Japan, how do you see the situation evolving there?

BW: Japan's problem is essentially a demographic problem. There has been a massive reduction in the dependency ratio, meaning far fewer workers to support a growing number of retired people. This is causing a slow rate of GDP growth, though in per capita terms – or perhaps even more important in terms of GDP per person of working age – it has risen significantly faster in Japan than anywhere else. So adjusted for demographics the Japanese don't have a problem. As former BoJ Governor Shirakawa used to say, we don't have a problem that requires the extraordinarily risky solution of printing money without limit.

But of course nominal debt doesn't get adjusted per capita. The debt is the debt, and it's 250% of GDP. Unless they find some means of raising nominal GDP growth they are going to run into some serious debt service problems down the road. So their problem is not one of more stimulus to raise demand and living standards. Living standards are okay. But it is one of a heavy debt burden, which is a different issue. It's rarely put that way in Japan, but I think what it comes down to is the need for faster nominal growth, i.e. higher inflation, as otherwise debt service requirements will get out of hand.

BS: In terms of the global monetary policy consensus, do you see a paradigm shift coming up, particularly regarding the 2% inflation target?

BW: I would make the argument that under certain conditions deflation ought not to be treated as a problem. If you've got positive productivity growth in an economy, prices will want to go down. Just think of consumer electronics, or white goods, where prices have been falling for years without causing any problems. If central banks resist these trends because they want 2% inflation then it is very likely that they will create imbalances that will lead to significant problems.

Looking back of over the last 20 years or so, I think there are grounds to believe that is precisely what happened. After the fall of the Berlin wall and after we had China coming back into the global markets, the increase in labor supply drove down wages and prices. Failing to recognize this development may have been one of the biggest mistakes that central bankers made. And all of those years of monetary pump-priming have created large debt burdens, which would grow further in a deflationary environment.

BS: How do you think all of this might affect central bank independence?

BW: I've always thought that the use of the word 'independence' in a broad sense was inappropriate because what central banks do in the context of a democratic society is that they have a mandate which comes with certain legislative powers. But it is government and parliament that set the mandate and to whom the central bank is accountable. In a democratic society every institution is a creature of government. So I think the use of the word 'independence' in its broad sense is not appropriate. It's a much narrower concept, and it's going to get still narrower as central banks go back to their historical roots. Central banks at their roots were about financial stability, not price stability. And now it's increasingly recognized, not just implicitly but explicitly through legislation, that central banks have got a responsibility for financial stability as well as price stability. This will require much more, messy cooperation with other arms of government.

BS: How do you view the Swiss situation, particularly on the exchange rate and monetary policy? Do you see a risk that

the new US administration might complain about the SNB's currency interventions?

BW: It's certainly possible, particularly as the new US administration obviously puts a lot of emphasis on trade. But this is not a novel issue. The Bretton Woods agreement was about preventing balance-of-payment problems that could end up in disaster. As John Maynard Keynes pointed out, it is the responsibility of both the debtors and the creditors to ensure that balance of payment crises do not happen. And Keynes originally suggested mechanisms through which countries with current account surpluses beyond certain limits would actually be punished. More recently, in the EU, a system has been introduced where countries with a current account deficit of 4% or more of GDP have to take measures of restraint, and those with a surplus of 6% or more have to take expansionary measures. In practice though, Germany is now up to 8% or 9% and nobody has done anything about it. For the Eurozone as a whole, this must be contractionary.

So the creditor has a responsibility and a very practical motivation to adjust. If the debtor can't pay there will be an international currency crisis, and the creditor might not get paid. It is therefore in the creditor's own self-interest to recognize that there could be a problem down the road and to make a contribution to solving the problem.

Switzerland may be too small to get the attention of the new US administration. But it has a very large current account surplus and a very large external asset position. And while it may be tempting to simply play along as a free rider, Switzerland should use a period of relative calm to support an adjustment of domestic production towards non-traded goods and services. This is particularly important since eventual international political pressure to revalue the franc might be accompanied by heavy capital inflows. Better to be prepared than to say it might never happen.

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Global FX Atlas: Border adjustments and the dollar

The Pulse of the Reflation Theme

Global Rates Landscape

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