Presentation to the Ambassadors to the OECD

Toulouse, France, 14 November, 2017

By William White

Introduction

Thank you for your invitation to address you today. It is a privilege that I greatly appreciate. The written Agenda for this part of your annual retreat states that I will address the question of how to "increase the impact of the OECD in the multilateral environment". I want to begin by suggesting that such an increase in impact can come either from "selling the product better" or "selling a better product".

Since I know little of marketing issues, let me focus on how the OECD might produce a better product. Such improvements will certainly benefit the member countries that you represent. Perhaps even more important, intellectual leadership from the OECD could provide a "nudge" that might fundamentally change the way economists approach policy issues.

The last time I spoke to you as a group was at your meeting in Deauville in 2012. Then, I enthusiastically supported the introduction of the NAEC program. Now, five years later, I wish to support the next phase of this initiative – the crafting of a "New Economic Narrative" based on the findings of NAEC to date. Let me explain why this work has received my strong support.

Traditional ways of approaching economic problems have led the OECD and the IMF, along with many others, to recommend to their clients overly short sighted macroeconomic policies. The traditional approach is premised on the assumption that the economy is a machine whose output can be closely controlled by its operator. Given this control, it seemed sensible to use all of our policy instruments to maximize the growth rate of real GDP, subject only to the constraint that inflation stayed at a low level.

The essence of the NAEC approach is to recognize that this traditional approach is inadequate and even dangerous. The economy is not an understandable and controllable machine, but a complex adaptive system like many in both nature and society. As a result, the objectives of policy must be extended well beyond the pursuit of strong GDP growth in the near term. First, a broader definition of “well-being” recognizes that economic outputs (GDP) are not the only contributors to human welfare. Second, growth must be sustainable over time, and there are many “imbalances” in complex systems (in addition to inflation) that can threaten that sustainability. Third, growth should be inclusive, benefitting the many and not just a few. This last imperative has not only economic benefits (increasing both demand and supply) but social and political benefits as well.

Shortcomings of traditional analysis

Since the crisis began in 2008, the G20 has repeatedly stated that the objectives of policy should be extended in the way suggested by the NAEC project. However, I sense that this development has not really reflected the **positive** embrace of a new paradigm; viewing the economy as a complex, adaptive system. That remains the objective of the “New Economic Narrative” now being proposed by the OECD. Rather, the new G20 approach reflects a **negative** assessment of where the traditional approach to policy has led us. It is being increasingly understood that we are now in a place where we do not wish to be, and that traditional ways of thinking have led us here.

Sustainability

The failure to think about the sustainability of our policies has had important implications for monetary, fiscal and regulatory policies. Each of them has now been pushed to the limits of its usefulness.

Starting with the”Greenspan put” of October 1987, monetary policy has been eased significantly in every downturn (or even threatened downturn) since. Since policy was never tightened as much in economic upswings, policy rates ratcheted down and eventually hit the constraint of “the zero lower bound”. Since then, a wide variety of unconventional monetary policies have been followed with scant (if any) regard for their possible unintended consequences. One result has been that global debt levels (household plus corporate plus government) have been rising steadily as a proportion of GDP for decades. Indeed, BIS numbers show that this ratio has risen by 40 percentage points of GDP since the crisis began. Should another downturn threaten, recourse to still more unconventional policies might well prove counterproductive.

Fiscal policy has been conducted in a similarly asymmetric way. Exploding deficits in downturns were never matched with surpluses in upturns. The result was that government debt ratios rose continuously over time. Whereas, in the distant past, governments sought in good times to pay down debts to prepare for war or calamitous events, the focus has shifted to merely maintaining access to new financing. The Eurozone crisis showed the limitations of this approach for a few countries, and provided stark warnings to many others. It is a simple fact that most Western governments are already technically insolvent. They will not be able to meet legislated commitments without massive increases in taxes. As with monetary policy, our room for fiscal expansion in the face of another downturn has been much constrained.

Financial regulation has also suffered from a similar form of short sightedness. A failure to recognize that the financial system is complex and adaptive, meant that regulation was largely directed to ensuring the health of individual banks. Not only did this neglect the possibility of systemic weaknesses (say shared exposures) but these regulations drove financial activity into the "shadows" and led to the shadow banking crisis of 2008. Since the crisis, the attempt to extend the boundaries of regulation even further have led to a massive increase in market based financing and the role of asset management firms. This "whack a mole" approach to regulation seems doomed to failure. Finally, financial regulators failed to take account of the negative effects of their tightening regulations on aggregate demand. This implied an even greater need for easier monetary conditions, with an even greater risk of undesired side effects.

Inclusiveness

The failure of policymakers to think adequately about inclusiveness has also had negative implications. While some attention is now being paid to the economic downsides, attention is being increasingly drawn to the political downsides. A pervasive sense of economic unfairness has developed which is destroying the trust needed to make a democracy work properly. In many countries today, "populist" movements bear witness to this lack of trust in the political and economic elites. There has been a sharp polarisation, away from the centre, towards the extremes of nationalism and socialism. Historical studies indicate that such tendencies are not uncommon after financial crises, and that they can threaten the rule of law in many dangerous ways.

The benefits of embracing "Complexity"

There are many benefits from embracing the notion that the economy is a complex, adaptive system. Not least, there are many other such systems in both nature and society, and other disciplines have been studying such systems for a long time. Macroeconomists could learn a great deal from these other disciplines since all complex adaptive systems seem to share many of the same properties. As well, embracing complexity means widening the range of objectives sought by policymakers, as described above. To put this another way, this approach identifies prospective problems that the traditional approach simply does not recognize. Moreover, this approach also provides guidance as to how we might more successfully pursue the objectives of strong growth, sustainable growth, and inclusive growth. Finally, this approach immediately raises the question of trade-offs, not least how the pursuit of short term benefits can entail longer run costs.

Strong growth

The first consequence of embracing complexity is that the emphasis shifts from the demand side of the economy to the supply side. While tight control over demand is not possible at any moment in time, it is still possible to nurture the development of the economy over time. Structural reforms to ensure the easy entry and exit of firms is crucial to support an evolutionary process. So too are reforms to ease the reallocation of factors of production from less efficient to more efficient uses, not least the reduction of employment protection legislation (EPL). Unfortunately, there is growing evidence that, in many respects, we have been going backwards in these areas in recent years.

To put this another way, we need to develop an economy which is more resilient to supply side shocks. Globalisation and the introduction of value added chains constitutes a recent such challenge which has not been well met in the advanced market economies. Looking forward, the principal challenge seems likely to be the introduction of new technology (robots, artificial intelligence etc.) which could dramatically increase productivity while hollowing out the jobs market, particularly for the semiskilled. How policy might respond to the plight of those most affected is discussed below under "Inclusive growth".

Sustainable growth

Another implication of embracing complexity is that systemic breakdowns (or crises) are regarded as inevitable. Moreover, the associated literature suggests that the amplitude of such disturbances are inversely related to their frequency according to a Power Law. This has a number of implications.

First, if crises are possible, it becomes a legitimate question to ask whether activist demand management policies can actually contribute to instability, as suggested above. If so, perhaps the objective of such policies should shift from maximizing the short term level of GDP (efficiency) to some combination of efficiency and sustainability. In the limit, a minimaxing objective that seeks to avoid really bad outcomes might be recommended. This way of thinking would seem to argue for more symmetric monetary and fiscal policies as well as a greater tolerance for small downturns. The latter would help prevent the cumulative buildup of the dangerous “imbalances” that led to the 2008 crisis and would also support the Schumpeterian process of “creative destruction”.

Second, if crises are inherent to the economic system, then policymakers should be prepared for them. This involves both taking steps before, to facilitate crisis management, and then actually intervening after the crisis has begun. Some aspects of the Dodd-Frank act imply the Fed’s capacity to do this in the future will actually be much reduced. Moreover, if similar constraints prevent the Fed from supplying dollar funding to financial institutions that require such funding, the implications would extend far beyond the United States.

Third, the complexity literature suggests that the “trigger” for a crisis could be anything. Policymakers should therefore rather focus their attention on indicators of growing systemic instability. Given the presumption of complexity and multiple possible “triggers”, it also seems likely that a single-minded focus on inflationary pressures will fail to identify other emerging threats to economic stability. Recall that the crisis that began in 2007 was not preceded by any significant increase in inflationary pressures, nor indeed was the Great Depression.

Fourth, in complex adaptive systems, problems will always arise in unexpected corners. Evidently this has implications for macroeconomic policy makers, but perhaps even more so for regulators. Ever more detailed regulations, designed to prevent the recurrence of old problems, positively invite evasion and the creation of new problems. The implication would seem to be a greater reliance on the self-interest of market participants and on market discipline as an alternative to regulation.

Finally, in complex adaptive systems the future is essentially unknowable. This implies that policymakers should rely less on forecasts and more on alternative scenarios, each implying the need to prepare an appropriate policy response. This statement also implies that what the future promises is not "risk" but rather what Keynes and Knight called "radical uncertainty". If so, then current estimates of the buffers (both fiscal and regulatory) required to deal with tough times are likely to be seriously underestimated.

Inclusive growth

Treating the economy as a complex, adaptive system implies that it is the interactions of many different microeconomic agents that determines overall macroeconomic performance. Given such a view, distributional issues really matter. They can affect both the demand side and the supply side of the economy, thus having the potential to put the economy on a different evolutionary path.

On the demand side, it has been suggested that a growing concentration of income and wealth in the hands of the richest in society can lead to chronic under consumption. In turn, this increases both the likelihood of increased monetary stimulus to offset this shortfall, and the likelihood that such stimulus will not work as intended, due to the rising "headwinds" of debt. This way of thinking implies that our current difficulties stem, in part at least, from underestimating the importance of distributional issues.

On the supply side, shocks (global or technological) that increase productivity will commonly put some groups of people out of work. The real policy challenge is to facilitate their finding new and rewarding jobs afterwards. This implies safety nets for individuals that are generous enough to allow time for retraining and job choice, but not so generous as to reduce the incentive to work. Governments also need active labour market policies that combine both carrots and sticks to encourage a return to meaningful work. Such policies are something of a magic bullet in that, by encouraging inclusive growth, they also contribute to growth being both stronger and more sustainable.

What might be done to reduce widening domestic inequality? Various "worker friendly" policies should be investigated. Could wages be allowed to rise without sparking an inflationary spiral? Record high profit spreads seem to point in this direction. Could more aggressive competition laws and enforcement levels bring prices and profits down? This would not only benefit ordinary people economically but would help reduce the political power exercised by those currently receiving monopoly rents. Could tax and transfer systems be further enhanced? Pushing all these issues higher up on the policy agenda, accompanied by concrete follow-up, would help restore a sense of fairness and the trust in government that arises naturally from it.

Why the OECD should play a leadership role

First, as all of the above comments indicate, embracing complexity implies that the OECD will be offering better products that will “increase the impact of the OECD in the multilateral environment”. However, how this is done also matters. I will return to this question of “who does what” at the end of my comments.

Second, whether reflecting the “mainstreaming” of NAEC or just happenchance, the OECD has been pursuing for a long time a number of the broader policy objectives associated with the embrace of complexity. Structural reforms directed to stronger potential growth have been a mainstay of the OECD’s work for decades. Concerns about inclusiveness have also been part of the OECD agenda for many years. Sustainability issues, related to both financial and environmental concerns, have also risen higher on the OECD’s list of priorities, particularly since the onset of the crisis. In short, this new approach does not imply a wholesale replacement of the products we currently provide to our clients. Instead, it provides a broader and more comprehensive analytical framework that, not only encompasses much of what we already do, but also points in the direction of new but related initiatives.

Third, most of the policy issues raised above are relevant to all the OECD member countries and many other countries as well. It would then seem natural for an international organization like the OECD to play a leading role. Moreover, to the extent that policy solutions might require international cooperation to resolve problems, leadership from an international organization would seem especially required. Individual nation-states are all too likely to focus on national priorities and to downplay the gains from cooperation. The “free rider” problem should not be under estimated.

Fourth, the OECD is well placed to take a leadership role. It has done so repeatedly in the past; think of the codes on capital account liberalisation and the BEPS initiative. It also has the trust of its members who will be inclined to follow its lead. As well, it has the unparalleled expertise in many sectors and disciplines required to support a systemic (multidisciplinary) approach to problem solving. And finally, with the NAEC project, it has already indicated a capacity and willingness to think in new ways that suit it admirably for a leadership role.

Finally, one must also recognize a reputational danger. What would be the adverse effects should the OECD try to lead a "paradigm shift" that fails to happen?

My view is that this is not likely. One reason is that this complexity approach is, in fact, not new but very old. As a recent book title put it, recognizing complexity is simply "The Rediscovery of Classical Economics" as practised by Smith, Ricardo Marx et al. These historical antecedents will strengthen its inherent appeal. Moreover, with modern computer power and "big data", the narrative approach of the classical economists can now be complemented with formal modelling of the sort that appeals to many academics.

Another reason is that academic economics already seems ripe for a change. Undergraduates at many universities are demanding changes to curricula to make them more relevant to the real world. PhD students are pressuring their supervisors to accept new analytical frameworks. Many Nobel Prize winners in economics, people with nothing to lose from attacking traditional analytical frameworks, have allied themselves with INET in the pursuit of New Economic Thinking. A "nudge" from the OECD, allied with other groups interested in the field (e.g. IASSA and INET), could make a big difference in accelerating a momentum that is already building.

Let me finish with a few practical considerations about "who does what" at the OECD in pursuit of this agenda. Given the emphasis on systemic problems and the need for a multidisciplinary approach, it would seem appropriate for some central agency to drive this effort forward. The Office of the Secretary General (OSG) has played a crucial role to date and should likely continue to do so.

That said, care must be taken not to repeat a mistake I have personally seen made at various institutions outside the OECD. If new work of a different character is to be undertaken, then new resources must be provided to do so.

Absent new resources, someone must be courageous enough to decide which old activities will no longer be carried out. The mistake is to say to Departments that they must carry on all the old work but with fewer resources. This strategy must be avoided since it is sure to backfire. It will seriously reduce staff morale, and will inevitably lead to documents full of mistaken facts, poor analysis or sloppy drafting. None of this will be good for the reputation of the OECD, particularly at a time when it is seeking to champion new ways of thinking.

I hope these comments will be thought helpful. I look forward to our discussion and to hearing various points of view.