

Uncharted Waters: When Economic Policy Solutions Become the Problem

Presentation by William White

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Economic policy premised on a fundamental ontological error

“It ain’t the things you don’t know what gets you. It’s the things you know for sure what ain’t so”

Mark Twain

- Modern macroeconomic theory is fundamentally flawed
- The economy is a complex adaptive system (CAS) with no equilibrium
- The economic system is nested in other CAS and is vulnerable to their failings
- CAS have multiple indicators of stress and “tipping points”

Economic policy solutions have become the problem

“ We have seen the enemy, and them is us”

Pogo, an American comic strip

- Expansionary monetary policy has encouraged private sector debt
- Government debt buildup is unsustainable
- Financial regulation has significant shortcomings
- Ever widening safety nets create longer term problems

Current indicators of economic and financial stress

“If I were you, I wouldn’t start from here”

Old Irish joke

- Slow growth of investment and productivity
- Record high debt levels of decreasing quality
- Stability of some financial institutions questionable
- Many asset prices historically high but volatility rising
- Markets functioning badly, including US Treasuries
- Resurgence of fraud and outright delusion
- Uncertainties arising from the Russian invasion and financial sanctions

Current indicators of stress in related systems

“If something cannot go on forever, it will stop”

Herb Stein

- Environmental systems stressed by population growth
- Political systems threatened by growing inequality and polarisation
- Public health systems threatened by covid
- An economic or financial crisis would threaten these other systems

Reasons to fear stagflation – negative supply side shocks

“When you come to a crossroad, take it”

Yogi Berra

- Pre pandemic resource misallocations
- Post pandemic hysteresis
- Population ageing in both advanced and developing economies
- Climate change and costs of mitigation and adaptation
- Energy shocks aggravated by Russian invasion of Ukraine
- Deglobalization and the need for “resilience”

Both Depression and High Inflation are plausible outcomes

“Some say the world will end in fire, some say in ice”

Robert Frost

- In CAS cumulative processes (positive feedback) are common
- High debt levels increase vulnerability in good times and bad
- The Debt-Deflation process described by Irving Fisher
- The High Inflation process described by Sargent/Wallace and Bernholz
- Both private and public debt pose problems. And we have both

Central banks likely to focus first on slower growth

“Take therefore no thought for the morrow. Tomorrow will look after itself. Sufficient unto the day is the evil thereof”

Matthew 6:34

- A repeat of the 1970’s? First support growth, then resist inflation?
- Central banks remarkably accommodating given inflation forecasts
- Fed’s new framework is more pro growth
- Belief that inflation shock is “transitory” and expectations “anchored”
- Uncertainty about effects of tightening (the “debt trap”)
- Amid geopolitical concerns and fears central banks will be blamed
- “Financial repression” in another guise?

A later pivot to tighter policy but....?

*“ Politics is not the art of the possible. It is choosing between the unpalatable and the disastrous”
J K Galbraith*

- Gap between real rates and restrictive real rates potentially wider
- And “debt trap” deeper and tightening likely more dangerous
- Indebted governments face environmental and military expenditures
- Implying a growing tolerance for higher inflation?
- And overt “financial repression”?

GOOD LUCK – YOU JUST MIGHT NEED IT