On the Need for Greater Humility in the Conduct of Monetary Policy[1]

Remarks by William R White

Introduction

Thank you for having awarded me the Hans-Möller-Medal for 2015. I am greatly honoured. My particular thanks to Uto Baader, the chairman of VAC Munich and also to the selection committee.

I have been in and around the central banking business for almost 50 years. Looking back on my career, I wonder how I was thought worthy of this honour since I recognize that for all my successes – generously described by Mr Baader in his award presentation - there have also been some significant failures.

One failure was that, for much of my life, I was guided by what I now see were a variety of false beliefs about how the economy works and how policy might contribute to its better functioning. In fact, a simple summing up of much of my early career might well be "I'm sorry, it seemed like a good idea at the time".

More recently, I think my beliefs have come closer to the truth, if there is such a thing, but I would also note that these beliefs have been by no means commonly accepted by the central banking community. Given that I was for many years the Economic Adviser at the BIS, trying to convince others of my beliefs, that too was a failing. That said, I do sense a greater willingness to accept these ideas in central Europe than in many other areas.

I want to spend a few minutes talking about past and current policy mistakes, both on my part and on the part of the broader central banking community. Recognizing how spotty the past record has

[1] Remarks to VAC Munich on the occasion of receiving the Hans-Möller-Medal for 2015.

been, I will finish with a few words on how we might do better in the future. I continue to believe there is hope for us yet.

Past Policy Errors

The fundamental assumption made by macroeconomists is that they understand how the economy works, and they can control it with their policy instruments. However, the fundamental problem with this assumption is that the structure of the economy is constantly changing. Policymakers that rely on static models of the economy, whether sophisticated econometrically or just ideas in their heads, are thus doomed to being constantly surprised. Let me give you just a few historical examples drawn from my own experience.

In the 1960's, the Bank of Canada had a **fixed exchange rate** with the US as did many others. They thought it was a good nominal anchor. However, the Bank eventually had to float the currency to avoid the inflationary pressures coming out of the US due to the unexpected effects of the Great Society and the Vietnam War. Later, other countries did the same and the Bretton Woods system collapsed. At the heart of this collapse was the fact that the US began to pursue its own interests rather than, as anticipated at Bretton Woods, the interests of the global system as a whole.

After floating we needed a nominal anchor and chose to focus on the Natural Rate of Unemployment and the size of the **output gap**. Unfortunately, changes to the Canadian unemployment insurance regime in the early 1970's lowered the Natural Rate in an unexpected way. Thus, our monetary policies were consistently too easy and inflation continued to rise.

Then the Bank decided to focus on the **money supply** in the mid 1970's, following the recommendation of Milton Friedman and the example of the Bundesbank. Unfortunately, that too failed for a whole host of reasons. The demand functions for money fitted well and were econometrically stable, but the error terms were too large to allow this methodology to guide our setting of interest rates. Then new innovations (e.g. sweep accounts) led to a huge and unexpected shift in the demand for money at banks. As the then Governor, Gerry Bouey, famously said “We didn’t leave the monetary aggregates, they left us”.

Monetarism was followed by a period of **eclecticism** as we tried in the 1980’s to guide inflation back down to an acceptable level of about two percent. As I remember it, the principal insight from that period was that a central bank, even if focussed on domestic inflation control, simply cannot ignore the exchange rate. We had periods of severe speculative pressure on the Canadian dollar that had to be resisted if the dollar was not to totally collapse. This implied setting interest rates higher than we thought appropriate for the domestic economy. Again, we were not fully in control.

As inflation fell back towards low levels, the view began to harden that the sole objective of Canada’s monetary policy should be to keep inflation low. This led in the early 1990’s to the Bank of Canada unveiling a new **inflation targeting regime.** This subsequently became very fashionable worldwide, although it was never formally adopted by the biggest central banks. It is a fact, however, that keeping CPI inflation at a low level continues to be the primary objective of central banks almost everywhere.

As with the previous regimes, I too was a believer at first. However, even while still at the Bank of Canada I began to have doubts. The catalyst for this was my observing the Japanese boom and bust, and recognizing that this had not been preceded by any significant degree of CPI inflation. Nor indeed had there been any significant degree of inflation prior to the Great Depression. These simple historical facts indicated that price stability, while desirable, was not sufficient to avoid serious economic difficulties.

After I came to the BIS in 1994, I became more and more convinced that the real problem was **excessive credit growth** and “boom-bust” cycles. Moreover, historical analysis indicated that, the bigger the “boom” the bigger the “bust”, with the downside also likely to be further aggravated if the financial system were weakened in the process.

This implied to me that that financial stability was also a desirable objective of government policy, along with price stability, although not necessarily that central banks should have primary responsibility for both. In short, recognizing that there were legitimate concerns about exchange rate fluctuations, and financial stability, along with price stability, implied that central banking was actually a more complex business than I had previously thought.

These credit driven “boom-bust” cycles are by no means uncommon. They have in fact been very common throughout history for anybody who cared to look. Unfortunately, perhaps especially in the English speaking world, both economic history and the history of economic thought received very little attention prior to the crisis.

We on the BIS staff tried to get this idea across to our central bank shareholders; namely, that credit excesses could lead to all sorts of dangerous imbalances in the economy. As a corollary, we also suggested that monetary policy (and indeed regulatory practices) had been systematically too easy for at least two decades. This process began with the Greenspan put in 1987, and was followed by numerous cycles in which monetary easing was always more vigorous than monetary tightening. This led policy rates to ratchet down to the zero lower bound. Similarly, it might be noted, asymmetric fiscal policy led to sovereign debt levels ratcheting up to levels that eventually threatened a negative reaction in financial markets.

The fundamental error of central banks over the whole period was the failure to recognize that global disinflationary pressures were arising from positive, supply side shocks. Productivity increases, as well as the effects of China and many other countries re-joining the global financial system, were exerting a constant downward pressure on prices. This “good deflation” should not have been resisted, as it was, by ever lower interest rates. This simply encouraged ever more leverage and debt accumulation, which culminated in the global crisis of 2007 and then the euro crisis of 2010.

So the bottom line is that central banks, and certainly me personally, made a lot of analytical mistakes in the past. Where are we now?

Current policy errors?

Note the question mark. It is important.

On the one hand, monetary policy globally since 2008 has been essentially “still more of the same” policy that got us into this mess in the first place. Monetary easing, both conventional and unconventional, is seeking to stimulate aggregate demand while downplaying the possible undesirable side effects. Unfortunately, the former effects are increasingly less noticeable, while the latter effects are becoming ever more noticeable.

The McKinsey Global Institute records that the ratio of nonfinancial debt to GDP for the world’s 47 largest economies was almost 20 percentage points higher at the end of 2014 than it was in 2007. The absolute increase was $57 trillion. In short, deleveraging has not really begun. The price of financial assets, just think of Bunds and equity prices, has gone through the roof as have property prices in many countries. Zombie companies are being kept alive by zombie banks and a sharp increase in Merger and Acquisition activity might also be contributing to growing “malinvestments”. Moreover, problems in the Advanced Market Economies have now spread to the Emerging Market Economies, with all of the BRIICS in deepening trouble.

On the other hand, and note well that there is now another hand, the level of debt is now so high that deflation would no longer be a good deflation but a “bad deflation”. Resistance by central banks would clearly seem justified.

Second, individual currency areas (including the Eurozone) have no choice but to react to the easy monetary policies being followed elsewhere. Otherwise they risk, through currency appreciation, other people’s deflationary tendencies being exported to them. At heart, we have a profound problem with an International Monetary System, or Non System, which allows everyone to do whatever they want in their own short term interests. “Sauve qui peut” is hardly an edifying description of a “system”.

Third, the central banks can rightly justify the current stance of policy as “buying time” for governments to address the fundamental problem of excessive debt and potential insolvency. Note that central banks can deal with problems of illiquidity, but only governments can deal with problems of insolvency and the distribution of losses. Further, only governments can support the other policies (e.g. more infrastructure investment and structural reforms) that might also help end the crisis definitively.

The bottom line is that, today, central banks everywhere are in a place where they do not wish to be.

Avoiding future errors

How can we do better going forward? In the spirit of Hayek’s Nobel Prize Lecture of 1974, “The Pretence of Knowledge” I think we have to admit that we do not – indeed, we cannot - understand how the economy works and that we cannot control it.

The economy is not a machine but a forest, a “complex adaptive system” like many other such systems that have been widely studied by biologists, botanists, anthropologists, traffic controllers, psychologists, sociologists, urban planners, military strategists and many other disciplines. Far from looking down on such people, economists could learn from them some exceedingly simple but important lessons.

First, all complex systems break down according to a Power Law. Lesson - be prepared.

Second, the trigger is irrelevant. It is the system that is unstable. Lesson- discover the indicators of growing instability and react to them.

Third, optimisation is impossible. We do not know enough. Lesson – focus on avoiding really bad outcomes.

Fourth, if the system is adaptive, trouble will always arise from an unexpected quarter. Lesson – do not fight the last war.

The bottom line is that, had policymakers practiced these Hayekian lessons in humility over the last forty years, we would not be where we are today. However, to avoid sounding too Austrian, let me also note that Keynes actually hinted at a similar view when he said “If economists could manage to get themselves thought of as humble, competent people on a level with dentists that would be splendid”. For both great economists, overreach was evidently though quite dangerous.

Conclusion

I have expressed some concern over both past and present monetary policy, but also some optimism about a better tomorrow. Let me then conclude by thanking you once again for having awarded me the Hans- Möller Medal for 2015. It is very much appreciated. And I thank you as well for your attention to my remarks.