Tools for the Next Global Recession?

Panel Remarks at the C D Howe Institute

By William White

I am delighted to have been asked to participate in this David Laidler luncheon "to recognize the outstanding accomplishments of David Laidler in the field of monetary policy". I have known David since the 1960's and benefited from his insights when I was at the Bank of England, then at the Bank of Canada (also from his joint papers with Bill Robson), and then at the BIS where he was a frequent and welcome visitor.

The topic being discussed today, "Tools for the Next Global Recession" presumes there will be one. Why would one think that?

Let me begin with a philosophical point. Epistemology is the branch of philosophy that studies the origins, nature, methods and inherent limitations of human knowledge. Modern macroeconomics, as practiced at the IMF, OECD and most central banks is based on a fundamental epistemological error. It assumes the economy has a **simple and static** nature. This means that it is understandable and controllable.

This current understanding, as reflected in modern macro models, is that big crises simply cannot happen, and that deviations from full employment and the undershooting of inflation targets are very temporary events. I would have thought that the Great Financial crisis would have refuted the first belief. I would also have thought that overestimating next years growth and inflation, in essentially every year since the crisis, would have refuted the second belief. Yet we have not yet had a paradigm shift in how we think about the global economy. This is unfortunate, perhaps tragic.

We should recognize the economy, not as a simple and static machine, but as a **complex and adaptive** system (CAS) like a forest. There are many of these complex, adaptive systems in nature and society. They have been well studied by other disciplines. Not least, they are constantly evolving in the search for greater efficiency in doing what they do. There is no such thing as equilibrium. As well,

and this brings me to todays topic, they break down regularly and sometimes catastrophically. Fundamentally, we need tools to confront the next recession, because there will always be another recession. Our knowledge is simply too limited to prevent this from happening.

A breakdown (a crisis) in a complex adaptive system occurs when a “trigger” makes an impact on a system that is already “stressed”. Unfortunately, when we think of the next global recession, there is no shortage of possible triggers nor of underlying (pre-existing) stresses.

As for “triggers”, the first point from the CAS literature is to expect the unexpected. History may rhyme but it never repeats itself, thanks to adaptation to whatever has come before. That said, tariff and currency wars might be the trigger for another serious downturn. It is not hard to imagine a global downturn in investment (like 2009) as uncertainty hits the C Suite. As well, every major region in the world has serious political problems to deal with (think Brexit and pension reform in Chile and France) and a failure to do so anywhere could easily hit confidence everywhere. Globalisation is a reality in the real economy, the financial system and through shared communications channels.

But it is the pre-existing stresses in the system that really matter. Each could act as a trigger for the next downturn, but together they will seriously aggravate whatever downturn occurs. My own view would be that it could easily prove deeper and longer lasting than what we saw in 2009.

The first stress point is global debt (households plus corporate plus sovereigns) as a ratio of global GDP. It has risen to around 230 percent of GDP from round 190 percent in 2008. While over all debt in the major Advanced Market Economies has flattened, debt in the Emerging Market Economies has exploded from 110 percent to 190. The IMF has recently estimated that 40 percent of all low income countries are either “in debt distress” or at “high risk”.

When we drill down, rising household debt and corporate debt is also a problem. Record high household debt in most English-speaking countries (ex the US), the Scandinavian countries, China, Brazil and other EMEs implies households will really have to hunker down (the “paradox of thrift”) in the next downturn. The rise in corporate debt in the US, Europe and China has also attacked huge attention, along with a deterioration in credit quality and increases in “currency

mismatch" problems. The BIS estimates there $11trillion of corporate debt issued in dollars by companies outside the United States. The IMF has recently estimated that a recession half as deep as the last one will reveal $19 trillion of corporate debt issued by companies whose debt service will then exceed their shrunken profits.

Closely related, global financial institutions are also under stress. Pension funds are underfunded, and threatened by an aging population. Insurance companies face similar problems. Banks too are under pressure, not least from the nascent Fin Tech industry. Since 2009, European banks have shed 60000 jobs to restore profits but are still trading at record lows relative to book values. Ditto for the Japanese banks, especially the regional ones. McKinsey Global has recently published a piece on the fragility of banks in South East Asia, more generally, while the problems of Chinese (especially regional) and Indian (especially state owned) are well known. All these institutions, including asset management companies, have embarked upon riskier investment strategies in a "search for yield" The latest IMF Global Financial Stability Report rightly flags all these developments as sources of serious concern.

When we look at financial markets, including real estate, we also see signs of actual stress or potential stress. As to the former, markets are increasingly driven by Risk-On/Risk-Off behaviour. Whole day go by without trade in JGB's. Flash crashes proliferate. Market anomalies (like the breakdown of covered interest parity) are increasing. And the inability of the Fed to control the repo rate is a further indicator that all is not well

As to potential problems, there are now $16 trillion of sovereign bonds with negative yields. They are being bought in anticipation of still lower yields and significant capital gains. Conversely as bond yields fall (indicating pessimism about the future) equity prices and real estate prices have been rising (indicating the opposite). Both cannot be right. What happens when one side capitulates? The potential for disorderly outcomes is huge.

So I repeat. It is entirely appropriate that we prepare for the next recession and that we ask whether we have sufficient tools to both manage the next crisis and to resolve it. And by resolving it, I mean emerging from the crisis with the debt overhang problem having been reduced rather than increased.

What tools do policy makers have available?

Monetary easing has been the preferred method to deal with downturns for some decades. It has always been eased more in downturns than it was tightened in upturns. This has certainly been the case since the crisis of 2009. The result was that nominal rates have ratcheted down to zero and monetary policy has had to turn to a whole host of unconventional procedures. In spite of all this, the recovery of aggregate demand in the AME's has been far weaker than in any post war recovery.

I want to suggest that we spend no time on how we can make monetary policy more effective going forward, especially thinking about negative interest rates. Monetary policy is caught in a fundamental inconsistency. The more it is used, the more private sector debt accumulation is encouraged. The "headwinds" of debt then make future monetary policy less effective, and in the limit ineffective or even counterproductive. That time has come. As Milton Friedman once said about the longer term relationship between money creation and inflation; "I have seen the long run and it is now".

Moreover, it is worth reflecting on all the stress point I have just listed. Almost all of these vulnerabilities have been made worse by monetary policy. To treat an insolvency problem (linked to too much debt) as an illiquidity problem that central banks can solve is to make a fundamental policy error.

Fiscal policy will have to be used more aggressively. In retrospect it was a mistake to put so much reliance on monetary policy the last time around. This is not to say fiscal policy is a free lunch. Indeed, the intergenerational accounting framework suggested by Larry Kotlikoff in the 1990's shows that virtually all the major governments are technically insolvent. The promises they have made in current legislation cannot be honoured without massive increases in taxes. That is the bad news, and further deficit spending will make it worse.

The good news is that the financial markets have shown immense patience in assuming that governments will eventually sort this problem out without recourse to higher inflation. I think this patience will be maintained, and that future deficits will not elicit a sharp rise in sovereign yields. That said, this could happen and

steps should be taken to avoid it. The OECD suggests that fiscal stimulus be directed to spending on truly useful things (infrastructure, mitigating climate change, early childhood education) and that a framework (debt brakes) be laid out for reducing sovereign debt ratios once the crisis is well and truly over.

Debt restructuring issues need much more attention than they are currently getting since the next crisis cannot be resolved without tackling the debt overhang problem. The first problem is that no creditor wants to recognize this as a necessary solution. They must somehow be convinced that 50 cents on the dollar is better than nothing, since that is what still deeper crises will produce. An orderly restructuring is always far less costly than a disorderly restructuring.

The second problem is that the judicial and administrative capacities to do this are insufficient in many countries. The OECD (Working party 1, the IMF and the Group of Thirty) have been making increasingly strident recommendations in recent years, to little avail.

So to sum up, there are global problems coming down the road and we have inadequate tools to deal with them. I am hoping that my colleagues on the panel will tell me to worry less because the situation in Canada is much more satisfactory. However, even if we can hope for the best, it is only prudent to prepare for the worst.