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William White: Central Banks Keep Shooting Themselves in the Foot

Mark Dittli | November 16, 2020

William White, former chief economist of the Bank for International Settlements, is taking central banks to task. Monetary policy over the past three decades has caused ever higher debt and ever greater instability in the financial system, says White. Fiscal policy must take over to deal with the current crisis.

William White has seen a lot in his professional life. He worked for central banks for almost fifty years, most recently for the Bank for International Settlements in Basel, where he was Chief Economist until 2008. Back then, he was one of the few officials who had warned of a looming financial crisis.

Today, the Canadian criticizes the central banks: “They have pursued the wrong policies over the past three decades, which have caused ever higher debt and ever greater instability in the financial system.”

He suggests that the current crisis should be used to rethink in order to build a more stable economic system, one in which fiscal policy plays a greater role and that relies more on productive investment. In this in-depth conversation, White says what should be done – and he demands more humility from decision makers: “We know much less about the economy than we think we do.”

Mr. White, the pandemic has caused the deepest recession since at least the 1930s. How would you rate the reaction of fiscal and monetary policy makers so far?

First, this pandemic again shows how little we know. We're dealing with a high level of uncertainty about its progression, and we all need a healthy dose of humility. Having said that, I'd say it was the right thing to do to open the fiscal policy spigots to prevent the economy from crashing. I'm more skeptical whether still easier monetary policy is the right answer for a shock of this character. In fact I hope we'll use this crisis for some serious soul searching on whether the monetary policy of the past thirty years has done more harm than good. But to fight the immediate effects of the pandemic, there was not much else policy makers could have done.

Let's focus on the fiscal side first: When is the time to withdraw the support?

Certainly not now. There is still room for maneuver on the fiscal side and we can still increase that room. Bond markets are wide open. Governments should use the current environment to borrow long and lock in cheap money while they can.

Are you not worried about rising government debt levels?

What I'd like to see is clear guidelines from governments about how they intend to get debt levels down in the future. I'm not talking about a German style debt brake here, but guidance on what types of expenditure cuts and tax increases they would be looking at. They should use this crisis as an opportunity to cut subsidies that often go to special interest groups that don't deserve them anyway. But let's be clear, this is not the time for austerity. I'd paraphrase St. Augustine: Lord, give me chastity – but not yet. That was the big mistake after the Global Financial Crisis: Most governments entered the austerity path too early and left it to the central banks to get the economy going. Sadly, that's been the pattern for the past thirty years.

How do you mean that?

Once upon a time, it was accepted that fiscal policy could play a productive role in dealing with a severe economic downturn. This is what Keynes gave us with the General Theory. But sometime in the 1980s, the belief system changed. Fiscal policy needed to be targeted, timely and temporary to be effective, but our legislative processes could not deliver. So fiscal policy grew out of favor. At the same time, starting in 1987 with Alan Greenspan at the Fed, monetary policy grew to be the instrument of choice for all kinds of crises.

And that was wrong?

We're on a slope where monetary policy has become increasingly ineffective in promoting real economic growth. Every crisis was met with monetary easing that caused debt and other imbalances to accumulate over time, and that caused the next crisis to be bigger than the previous one. The next crisis then needed more punch from central banks. But since interest rates were never raised as much in upturns as they were lowered in downturns, the capacity to deliver that punch was decreasing.

In March of 2020, the financial system was on the brink of collapse with widespread panic in equity and bond markets. The Fed ended that panic by announcing they would buy corporate bonds. Is that not strong proof that monetary authorities are in fact very effective?

This episode perfectly encapsulates my view of what's wrong with our monetary policy of the past decades. True, the Fed had no choice but to step in to prevent a financial meltdown. But this meltdown only happened because of the monetary policy followed over previous years. You see, by keeping interest rates too low and thereby trying to create economic growth, central banks are inducing corporations and households to take on more debt. To a large part, this debt is not used for productive investments, but for consumption or, especially in the U.S., for the buyback of shares. This creates a debt trap as well as rising instabilities in the financial system. These instabilities broke out in March and the Fed responded adeptly to stop the panic. But my point is: Central banks create the instabilities, then they have to save the system during the crisis, and by that they create even more instabilities. They keep shooting themselves in the foot.

Have central banks reached the end of the road?

Just read what Bill Dudley, the former president of the New York Fed, [wrote in Bloomberg] a couple of weeks ago. He warns that central banks have run out of firepower, and he warns that the side effects are getting worse. I agree with every word. That is the most dangerous effect of the past thirty years of monetary policy: Debt levels have constantly been building up, and so have the instabilities in the financial system.

Jerome Powell has tried to normalize monetary policy, but he had to stop after a market panic in late 2018. Is the Fed hostage to financial markets?

This is exactly my definition of the debt trap: Central banks know they can't leave interest rates as low as they are, because they are inducing still more bad debt and bad behavior. But they can't raise rates, because then they would trigger the very crisis they are trying to avoid. There is no way out but to keep doing what you are doing, but by doing that, you are making it worse. Pretty uncomfortable, right?

After the Financial Crisis, there was a lot of talk about deleveraging the system. Nothing happened. Why?

In 2008, the ratio of global household, corporate and government debt to GDP was 280%. Early 2020, this ratio had grown to 330%. And it's not just the quantity of that debt, it's the quality. Most of the new corporate debt is BBB-rated, covenant light, low quality stuff. The reason for that is the ultra-easy monetary policy we have seen post-2008. Governments made the mistake of embracing fiscal austerity too early. By that, they left the job to the central banks to frantically try to create economic growth. This is a mistake we must avoid after this crisis. Fiscal policy will have to play a much larger part going forward.

Central banks have argued that their easy monetary policy is needed because inflation was too low. Were they correct?

No, that was a misconception. Starting in the late 80s, we had a series of positive supply shocks to the world economy, most important of all the establishment of China as a manufacturing economy, as well as the collapse of the Soviet Block. Hundreds of millions of workers thus entered the capitalist world economy. At the same time, the members of the Baby Boom Generation grew their way through the Western economies. This manifested itself in a sustained positive supply shock that had a strong disinflationary effect on the world economy.

So central banks tried to fight a disinflation that was in fact benign?

Exactly. There are periods of low inflation or outright deflation that ought not to be of concern for central banks. If prices want to go down because of productivity increases: What's wrong with that? Productivity increases give you higher profits and lower prices, which is the way productivity gains are shared between the entrepreneurs and the consumers. There is a raft of pre-war literature on the topic of benign deflation, but our central banks have forgotten about it.

And yet, one of the most steadfast arguments for their policy is the undershoot of inflation. The Fed even changed its inflation mandate to achieve «on average 2% over time». What do you make of that?

When you have a lack of demand and high unemployment, then it absolutely makes sense to pursue an easy monetary policy. My problem is that, over many years, central banks have done everything to fight this perceived undershoot of inflation, regardless of its cause. They pulled out all the stops, not least by imposing negative interest rates in the Eurozone, which weakened their banking system. Despite measures of inflation being so imprecise and so unsure, as repeatedly noted by the late Paul Volcker, many central bankers have been willing to pull out all the stops in response to decimal point deviations. That, to me, is hard to justify.

Looking forward, can there be such a thing as normalization in monetary policy?

There is no return back to any form of normalcy without dealing with the debt overhang. This is the elephant in the room. If we agree that the policy of the past thirty years has created an ever growing mountain of debt and ever rising instabilities in the system, then we need to deal with that.

How?

In theory, there are four ways to get rid of an overhang of bad debt. One: Households, corporations and governments try to save more to repay their debt. But we know that this gets you into the Keynesian Paradox of Thrift, where the economy collapses. So this way leads to disaster. Two: You can try to grow your way out of a debt overhang, through stronger real economic growth. But we know that a debt overhang impedes real economic growth. Of course, we should try to increase potential growth through structural reforms, but this is unlikely to be the silver bullet that saves us. This leaves the two remaining ways: Higher nominal growth – i.e. higher inflation – or try to get rid of the bad debt by restructuring and writing it off.

Which way will it be?

Probably a combination, but they are all very hard to achieve. It's fairly obvious that a number of policy makers will try to inflate the debt away. This was how they did it after World War II, through what we now know as financial repression: Get inflation above interest rates, and then the debt ratio gradually comes down. It's just very hard to engineer the kind of inflation that is just right for this process.

A number of heavyweight economists are suggesting exactly that: Engineer inflation levels of 4 to 8% over a number of years to inflate the debt away.

Sure, that's what Larry Summers and Olivier Blanchard are saying. Perhaps that's possible. My only point is that they are starting with the assumption that the nature of the economy means it is understandable and controllable. But I'm saying we are dealing with a complex adaptive system, full of tipping points, and we should not assume that we can understand and control it. On the one hand, in depressed circumstances, it might prove impossible to raise inflation. On the other hand, given enough fears of fiscal dominance, you might get a lot more inflation than you bargained for.

The period of financial repression after World War II had another prerequisite: capital controls to prevent capital flight. Are they feasible today?

When I started working at the Bank of England in the late 1960s, the biggest department in the place was Foreign Exchange Control. In the modern world, is it really possible for a single government to control the outflow of capital in the way that would be required? I doubt it. Yet, if a number of large governments simultaneously embark on a path of financial repression, it raises the question of where capital might flee to? Gold? Bitcoin? In such an environment, I would be worried if I were Swiss. People might see the Swiss Franc as one of the currencies to flee into. Financial repression has the potential to be a messy process.

What about the fourth way: write-offs?

That's the one I would strongly advise. Approach the problem, try to identify the bad debts, and restructure them in as orderly a fashion that you can. But we know how extremely difficult it is to get creditors and debtors together to sort this out cooperatively. Our current procedures are completely inadequate.

How so?

Let me give you two examples: It was clear that the best way forward for Greece after their crisis of 2010 was a comprehensive debt relief in return for structural reforms. However, policy makers in Berlin and Brussels never agreed to the level of debt relief that was needed, and so they pushed Greece into a destructive austerity spiral. Or look at government debt in Sub-Saharan Africa today: A lot of it has to be written off. Otherwise these countries are going to be forced to continue to try to pay, and they will do it at the expense of healthcare and so on. That's a recipe for human disaster. But we are dealing with public, private and Chinese creditors, who are competing to be paid. Why should a Western private creditor give up his claim if the Chinese don't? Unfortunately, recent legal rulings like NML Capital versus Argentina have taught creditors that it's best to hold out. So, all over the world creditors don't agree to restructurings but rather extend and pretend that the debt is still viable. And it's all made superficially viable by easy monetary policy.

It almost seems the easiest way is to just keep doing what we are doing?

You are right. My colleagues at the BIS and I have been warning of this debt trap issue for twenty years. I am reminded of the economist Herb Stein who once said that, if something cannot go on forever, it will stop. To which Rudi Dornbusch quipped: Yes, but it will go on for a lot longer than you anticipate. One of the reasons for not changing anything is indeed the argument that it has worked so far. What is needed now is agreement that our policies of the past thirty years have created an ever rising level of debt and ever increasing instabilities. Should it be agreed that this path is not sustainable, as it leads to ever bigger crises, it's an absurd proposition to stay on that path.

Knowing that complex adaptive systems are prone to tipping points: What could derail this system?

I don't know. One of the conclusions of the complexity literature is that the trigger itself is irrelevant. If the system is unstable, anything could be a tipping point, even if the instability goes on without incident for years. Again, take the episode of March 2020, when these corporate giants in the U.S. were wobbling. The Fed stopped the panic. What if markets at that point had lost confidence in the ability of the Fed? We only know in hindsight that it worked. But we don't know how the system will react in the future. In fact we know much less than we think we do, which is something that both Hayek and Keynes, commonly described as being at odds, totally understood. Central bankers, indeed all macroeconomists, should be much more humble than they are.

You said that we should use this crisis to build a better system. Apart from dealing with the debt overhang: What do you envisage?

One, I think population aging means we have to build a system that relies much more on productive investment to support both current demand and future pensioners. When I said that fiscal policy has more room in the next few years, it's absolutely clear to me that there is a lot of potential for good, productive public infrastructure investment, particularly in America and Europe. Again, debt is not a problem as long as it is used for productive investments. Two, we need a corporate system that relies more on equity and less on debt. Managers, particularly in the U.S. and the UK, who took on more debt just to buy back shares to boost their stock options, have acted irresponsibly. Cutting back on capital investment for the same reason is even worse. This bonus culture is wrong. Three, we need a system in which there is more competition and less concentration. Monopolies have been quietly building in the past years, and these monopolies use their extra profits to gain political control. Four, we have to realize that the problems in our political system – populism, alienation, distrust – have their roots in our economic system: in particular, rising inequality. We'll have to deal with that.

How?

When this pandemic is over, we will see rising marginal tax rates, we will have to talk about wealth taxes, and there must be a much more robust crackdown on the shifting of corporate taxes and criminal tax evasion. And, of course, we'll have to deal with climate change, a clear and present danger that only people in denial refuse to accept. These are huge tasks.

Are you optimistic that we'll master them?

I honestly don't know. We'll need a paradigm shift in our thinking, and we know from history how difficult that is. I mean, both Copernicus and Darwin delayed publishing their work for years because they knew how much their ideas would upset the establishment. Since the Reagan-Thatcher Revolution of the early 80s we've worked with a set of beliefs. And some of these beliefs have turned out to be wrong. These false beliefs need to be changed.

Such as?

The idea that price stability is sufficient for economic stability? Wrong. That easy money always stimulates demand? Wrong. That the economy is self-adjusting, back to a full employment equilibrium? Wrong. That financial markets are efficient and bad things can't happen? Wrong. That wealth will trickle down to all levels of society? Wrong. These are big beliefs. And false beliefs are dangerous. You know the saying attributed to Mark Twain: It ain't the things that you don't know that get you, it's the things that you know for sure, that ain't so! Never forget: We think we know much more than we really do.

William R. White was chief economist of the Bank for International Settlements (BIS) in Basel from 1995 until his retirement in 2008. He was one of the few who had warned of the dangers of a global financial crisis before 2008. From 2009 to 2018 he was Chairman of the Economic and Development Review Committee of the OECD in Paris. White began his career in 1969 as an economist in the service of the Bank of England and has fifty years of experience in monetary policy. He has published widely on topics related to monetary and financial stability. He lives in Toronto.