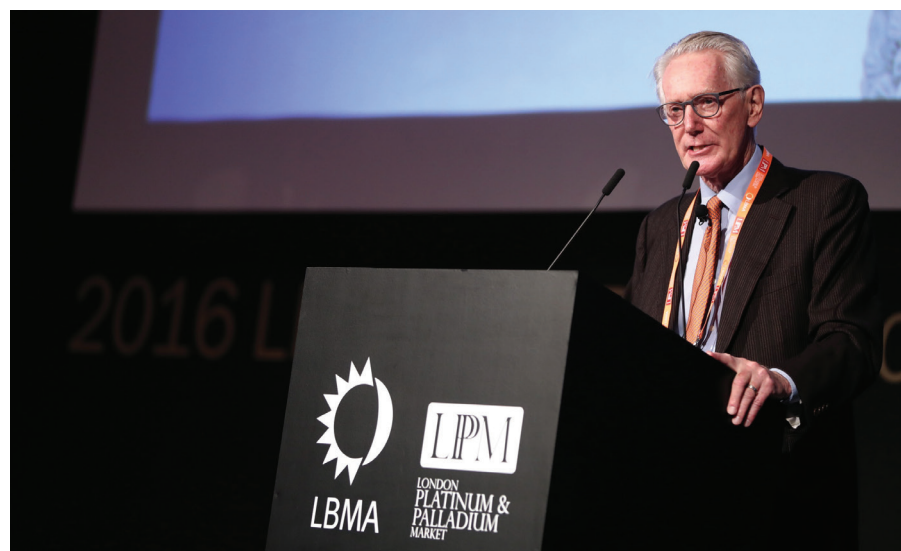


Ultra Easy Money: Digging the Hole Deeper?

By William White, Chairman of the OECD Economic and Development Review Committee



Ultra Easy Money

For the moment, let me talk about ultra easy money and monetary policy, the consensus view on the global economy. I was just looking at the recent OECD outlook, and the IMF outlook is much the same. If you look at the prospects for 2017, growth globally is going to go up. If you look at the prospects for inflation, inflation is going to get higher – it is going to get closer to the 2% that everybody wants. Now, I have to point out that this has been the forecast for nine years in a row: things are going to get better and inflation is going to go up. It has been nine years in a row.

What is driving those forecasts? The answer is that the model these people all use is one that basically treats the economy like a machine. It is a machine that is understandable and controllable and it is in the competent hands of its operators. I actually believe that is wrong. We are not going back to equilibrium, which is the premise of these forecasts – and the forecast errors for the last nine years. The economy is not a machine, the economy is a forest. The economy is what they call a complex adaptive system, in which there are millions and millions of people interacting, changing their views, learning from other people as we go.

In these complex adaptive systems – there are many other disciplines that study this stuff – there is no equilibrium to go back to. You are on a highly adaptive path that could lead you anywhere. The only thing we do know about these paths is that where you go to depends on where you came from. The economy is path-dependent. What I want to suggest here, in this path-dependent system, is that monetary policy over the course of the last 30 years has put us on a bad path.

The reason why I say that – just to give you some background – is this. When we had a problem in 1987 – some of you may be old enough, long enough in the business to remember that, – the answer was, ‘print the money’. And when we had a problem in 1990 and 1991, the answer was, ‘print the money’. And when we had the difficulties in South East Asia and LTCM in 1997 and 1998, the answer was, ‘print the money’. And in 2001, when the economy tanked, the answer was, ‘print the money’. I think that has given money, and the associated increase in credit and debt, a very important and dangerous role which it is playing out even as we speak.

This is a transcription of the Keynote speech delivered by William White at the LBMA/LPPM Conference in Singapore, 16-18 October, 2016.

When you are invited to speak and people have heard you before, it is always a tremendous thrill. I am going to speak today about ultra easy money and digging the hole deeper. The reference, of course, is to the activities of the central banks, who have been at the centre of virtually everything for the last seven or eight years. I think it is very important that we talk about what it is that they have been doing.

Knowledge and Policy

The basis of policy is always knowledge: knowledge about how the economy works. When you start talking about knowledge, you raise some very significant problems. You can have too little knowledge. You may remember that a number of years ago Donald Rumsfeld said: “There are known knowns, there are things we know we know. We also know there are known unknowns; that is to say we know there are some things that we do not know. But there are also unknown unknowns – the ones we don’t know we don’t know.” The absence of knowledge causes problems. However, there is another problem with knowledge: when you think you know, but you do not – and you think you know very strongly. Mark Twain said something about this 100 years ago. He said: “What gets us into trouble is not what we don’t know. It’s what we know for sure that just ain’t so.” I guess what I want to say is that I think the belief system of the central banks, which has motivated this policy of ultra easy money

for the last seven or eight years, is, in a certain sense, based on some false beliefs. Those false beliefs are, essentially, that monetary policy will work to restore strong, sustainable growth and, secondly, that those monetary policies do not have any unintended consequences of any significant nature. I happen to believe, personally, that both of those beliefs are wrong.

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We will have a panel here, shortly after the coffee break. Because my views are rather extreme, I will, of course, be asking the panel whether they agree or disagree with the things I have said about the risks and the prospects ahead. Of course, we will also be asking them – because the panel members are much more familiar with the gold market than I am – what all of this macro stuff means for the gold market. You have all of that to look forward to as well.

The Global Financial Crisis

Let me say a few words about the lead-up to the crisis that started in 2007, against the backdrop of all of that easing that had come before. How did we get into trouble in 2007? I want to suggest that, if you go back and you look at the history of financial crises, they all look exactly the same. I am sorry. They are not exactly the same. In essence, they are the same. The essence of them is that they all start off with something good happening – something that justifies confidence and exuberance. In this case, it was the fall of the Wall and the changes in demographics. The demographics were good. You had all of the countries that used to be command and control coming back into the world trading system. This led to a kind of secular trend towards lower inflation. Times were good.

The unfortunate point, however, is that in the system we have, which is a fiat money system, where the banks essentially create money out of nothing, it is very easy for rational exuberance to turn into irrational exuberance. Leading up to the crisis of 2007, that is precisely what happened. If you think back about what was going on at that time, we had both real and financial imbalances leading up to 2007. On the real side, for example, in all the English-speaking countries, the household savings rate went down to zero. People basically spent every penny that they got. When you looked at a place like China, the investment ratio went up to about 45% of GDP. We have never seen anything like that before in history.

We had some real problems and they started in the advanced market economies, but then they spread out to the emerging market economies, basically through the regime of semi-fixed exchange rates. I will come back and say a bit more about that range of territory in a moment. In short, there was a degree of exuberance there and imbalance that, as I put it here, was an accident waiting to happen. The astonishing thing about it –

this, again, goes back to the competence of the central bankers and others – is that it was an accident waiting to happen and everybody missed it. You should think back about that.

The regulators missed it, because the regulators were all focused on individual financial institutions. If they were healthy, the system was healthy. That is not true in a complex adaptive system. The central bankers were all saying 'price stability is the only thing that matters. We have price stability, so everything is fine.' That is not true. Politicians believed at the time that what they were seeing, with all the fiscal inflows, was permanent and not temporary – so they spent all the money. That was not true. I would say it was the same thing on the private side. All the people who were making large amounts of money leading up to 2007 all said: 'It is alpha. I am really smart, and that is why I am making so much money.' In retrospect, it was not alpha. It was beta. They were taking big risks and they got caught out.

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Moving Forward

As we look back on it, there is not so much to be proud of – but where do we go from here? For a start, it has not worked the way people expected. You have to remember that we are eight years into ultra easy money and none of us has the feeling that everything is going to be okay. Increasingly, we feel the opposite. Now, why is that? Why is it not going to work as intended? It is premised on the idea that easy money will stimulate aggregate

demand, but – notice the big 'but' there – it increasingly smacks of panic. People are looking at what the central banks are doing and they are saying 'there is something fishy in the state of Denmark. There is something wrong out there.' What do you do when you start to worry like that? You do not step up to the bar and buy another drink, you just hunker down. That is what you do when you think things are going seriously wrong.

You also have to think about the way monetary policy works. Basically, the way it works with low interest rates is that you are asking people to advance their spending from the future to today. The problem with that is that if you advance your spending from tomorrow to today, then of course you have to reduce your spending tomorrow because you have already spent the money today. To put it another way, the spending involves an increase in debt – and the debt, as Chairman Greenspan put it, is a headwind against future spending. All of this is to say that I am not so sure it is going to work.

If you look, for example, at consumers and you run down the various components of demand, there are all sorts of reasonable arguments why consumers will spend less, not more. One of them that is getting increasing attention is that, if the roll-up rate – let us say you are saving for an annuity or a pension – goes down, what do you do other than work longer? The only thing you can do is to save more in order to get more savings to buy the annuity so you can have a reasonable retirement. The whole thing works backward – at least potentially.

I would say it is the same thing with corporate investment. One of the reasons why corporate investment is so low is because the investors in corporate investment are looking ahead to what the consumers will do. If they can foresee that the consumer no longer has the wherewithal for further spending, they are going to cut back themselves. Another thing that is getting increasing attention both in the United States, the UK and increasingly in Europe and Japan is this whole business about the interaction between easy money and management compensation. Andrew Smithers from the *Financial Times* calls it a 'no brainer'. Why are corporations buying in so much equity? One of the answers is that it pushes up the share prices, and the share prices are related to their bonuses. It is a 'no brainer'. They cut back in investment in exactly the same way – to retain cash to do the buybacks. What you have here is a situation of systematic stripping of assets out of the corporations. As I put it, a very dangerous situation.



I would note that this is exactly what Keynes himself suggested. People talk about these policies as being Keynesian – they are absolutely not Keynesian. They were the Keynes of 1931 when he wrote *A Treatise on Money*. By 1936, what he said was: ‘If we are tempted to assert that money is the drink which stimulates the system to activity, we must remind ourselves that there may be several slips between the cup and the lip.’ Keynes himself, by 1936, had repudiated the very policies the central banks are following today.

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Unintended Consequences

It is not going to work, and my concern would be that it is going to have a lot of unintended consequences – and these consequences are material.

For a start, there will be consequences for debt levels, to which I alluded a moment ago. McKinsey and Company came out with a report last year that pointed out that global debt levels are now 20% higher as percentage points of GDP than they were in 2007. If you think a crisis period is a period when you get all the deleveraging, think again. It has gone in the very opposite direction – and that is a real source of concern.

In the advanced market economies, asset prices have been raised to unsustainable levels. It is very hard, as you all know, to determine what one means by ‘sustainable’. We all have different views about the fundamentals, but if I look at equity prices, they are pretty richly priced. Bond prices are the same. We have \$10 trillion of bonds that are yielding negative rates. Surely, this is totally unsustainable. If we look at the yield spreads, particularly for high-risk, they seem very, very low. If we look at the VIX or virtually anything else you want to look at, you can ask questions about the sustainability.

I worry about market functioning in light of what the central banks have done. If central banks are the only game in town, when setting prices, everybody is focused on what the central banks are going to do. In itself, that destroys the process of price discovery – and that is very, very unhelpful. Worse than that, it is not just that the correlations between the asset classes have gone up very, very high, everybody is into ‘risk-on, risk-off’ mode. We have seen this continuously since 2007. What it really means is that everybody

is focusing their attention on the tails, but if people are focusing all their attention on the tails, where is diversification? Where is value investing? All of that stuff has just gone out of the window, so I do not like that either. In respect of financial institutions, we are increasingly talking about the threat to spreads and whether pension funds and insurance companies can survive. You saw the reports the other day from JP Morgan. Profit levels are down basically everywhere, particularly for large institutions. That is worrying, too. EME corporates – this audience will know this better than me – have seen a huge increase in the issuance of corporate debt – particularly in China, but in Asia more generally and also in Latin America. A lot of the debt has been issued in dollars, but the revenues are, of course, in domestic currencies. As the dollar rises, the question becomes about the capacity for debt service.

I will not go into the other unintended consequences, but there is the issue of moral hazard and people being invited to do silly things because the interest rates are so low. There are distributional consequences, and more and more attention is being paid to this now. It is the rich who own the financial assets that are going up, and it is the average guy who is getting squeezed.

Economic and Political Dangers

When you put it all together, there are more dangers now than there were in 2007. This is a highly disputable assertion, however, to which I am sure we will come back in the panel. I would just note – I will do it quickly, because we do not have a lot of time and Eric is coming back to it, too – that every major geographical area has serious economic problems. There is a growing acceptance that Abenomics is not going to work. It has not worked and it is not going to work. China is in the middle of a huge regime change from export and investment-led growth to consumer growth. This is not going to be easy. Europe – I will say no more about Europe. We all know Europe has a lot of problems. Even in the United States, productivity growth has been falling – the productivity rate was falling until very, very recently. Investment is weak. Inequality is terrible in the United States.

Everywhere you look, there are problems – and they are often compounded by political difficulties. You think about debt ceilings in the United States, the political problems in Europe and, in China, the battle between the people who want real reform and the state-owned enterprises who like the way it is. There are political problems everywhere. The reality – I have used this phrase a number of times – is that this is a complex adaptive system. We are all in this together now. The global economy is linked together through trade, financial markets and even the Bloomberg screen. We are linked together in ways we have never been linked together before. What that means is that if we have problems anywhere, we are going to have problems everywhere – because that is the way it works. This is something

we should be careful about. I would note that there has been some careful empirical work about these kinds of spreading phenomena by both the IMF and the OECD. The results of some of the simulations they have done are not really very pleasant.

The last bullet here is that our macro tools are all used up. We can come back to this in the panel. There is very little room on the monetary side, I think. On the fiscal side, when I talk about the debt levels having ratcheted up, it is important to note that a lot of it over the course of the years has been government debt levels – particularly in the advanced market economies. They have basically been using up their fiscal room to manoeuvre at the same pace as the central banks have been using their monetary room to manoeuvre.

Predictions

Well, where do we go from here? I can tell you a sort of happy story and I can tell you a not so happy story. Let us start with the happy story. Let us assume that the global recovery strengthens – and there are some indications that Europe is getting better and the US may roll along. Let us assume the global economy strengthens. What happens in the financial markets? Well, I think the first thing to say is that policy rates and the long rates, in that stronger growth scenario, will go up. We hope – I will come back to this in a second – they will go up in an orderly way. We hope even more they would go up less rapidly than the rate of growth of nominal income so the debt ratios can just gradually work off. I suggested that all of those asset prices were pretty stretched, but if that happens, people will say: ‘Well, they got ahead of themselves, but it is probably going to be okay.’ I think that is probably what will happen.

But there are some risks even in this good scenario. One of them – given that we are, in most countries, not so far away from full capacity – is that it is not unlikely that inflation might start to rise and it would rise in such a way that it would prompt, eventually, a pretty significant response on the part of the central banks. In the past, of course, that has always led to a recession, which is not a good news story. That is the good news hypothesis, but I can see one risk at least. There is a second risk. It is not so obvious that when things start to look better, the bond markets and the other markets would react in an orderly way. The rates are so low now at the long end, the likelihood of a major movement exacerbated by momentum trading seems to me to be not implausible. A number of references were made earlier on to regulation and the unexpected consequences of regulation. One of them is clearly that the liquidity in a lot of markets is prone to dry up in situations where the markets are moving rapidly. If that is the case, I think it is more likely to produce a disorderly rather than an orderly exit. That, again, would threaten the assumed recovery.

I am going to tell a less pleasant story. I am getting close to the end now. That is that we get an assumed slowdown or a global recession. Well, in that case, of course, the policy rates would stay low; the long rates would stay low. However, all of those other financial asset prices that look rich, I think, would fall sharply, which of course could increase the likelihood of a still further slowdown. I suspect, in that situation, you could look forward to a period of financial repression. We are back again, somehow, to a mix between the regulatory side and the monetary policy side. Efforts would be made to ensure that, somehow, you were forced to buy government bonds or maintain liquidity ratios. I mean macro-prudential, things of that sort.

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I mention this in passing, but in countries that started off with a very bad fiscal situation, there is a lot of history that indicates that a slowdown, when a country faces a very bad fiscal situation, leads to still more recourse to the central bank and to people, ordinary people and traders, seeing the writing on the wall that central bank financing will eventually lead to inflation. Everybody says: ‘I am out of here.’ There is a currency collapse and hyperinflation. We have seen it many times in history in the worst of the worst-case scenarios.

Good Luck

I will basically skip this because of the time. Could governments help? I will ask the panel this. I think we have run out of room on monetary policy. I am pleased to say that the central bankers seem to be agreeing, increasingly. I wish they had agreed five years ago. This means governments have to step in, in one form or another. There are various things they could do. The sadness about it is that even if you can see a way in which governments could get us out of all of this mess we are currently in, they are not going to do it. Such changes are unlikely. I think this has its roots in psychology. Changing your view of the world is always extremely hard, and it is never harder than when you are in the middle of a crisis and you really want to hold on to the old beliefs. The likelihood of this happening is not very great. There is a way out on the economics side, but there is no way out on the political side.

When Joseph Schumpeter was once asked, ‘what is the essence of economics?’, he famously answered, ‘politics, politics, politics’. Finally, I wish you good luck – you just might need it.



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The committee conducts country reviews and gives

policy advice. He was also a member of the Issing Committee which advises the German chancellor on G-20 policy issues (named after Otmar Issing, a German economist). From May 1995 to June 2008, he was the Economic Adviser and Head of the Monetary and Economic Department (MED) at the Bank for International Settlements (BIS) in Basel. He has published many academic and journal articles on topics related to monetary and financial stability as well as ways to improve the process of international cooperation in these areas.

Disclaimer: Mr William White was speaking at the Conference solely in his personal capacity.