Evolving Challenges for Monetary Policy Looking Back and Forward

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Conference at Bank Negara Malaysia
Kuala Lumpur, Malaysia
21May, 2014

"If I were you, I wouldn't start from here"

- Subpar global growth since the crisis began
- Economic forecasts suggest improvement
- But what do forecasters know about complex systems?
- Every geographical region looks fragile
- And our macro policy ammunition is gone

How did we get to where we are?

- Monetary policy guided by flawed theory
- Easy money led to inflation in the 1970’s
- “Greenspan put” replaced Volcker discipline
- Followed by asymmetric policies for 20 years
- Resulting in the buildup of record debts and a host of economic “imbalances”

The run up to the crisis of 2007

- The "fall of the wall" and global disinflation
- Irrational exuberance in AMEs and imprudent credit creation
- Leading to "still more" debt and other imbalances
- Spreading to EMEs via semi-fixed exchange rates
- In short, an accident waiting to happen!
- And the policy makers missed it!

What might policy have done differently?

- Central bank tightening in response to credit bubble
- Financial regulators tougher and more systemic in focus
- Greater use of macro prudential instruments
- Lenders encouraged to admit “alpha” is “beta”
- Borrowers encouraged to believe in “regression” not “extrapolation”
- Government expenditure caps
- International monetary cooperation

Crisis in the AMEs and the policy responses

- Fiscal expansion supports demand
  BUT raises sovereign debt
- Support for financial sector avoids collapse
  BUT impedes debt deleveraging
- Support for industrial sector saves jobs
  BUT impedes needed adjustment
- Ultra easy monetary policy (UEMP) tries to support demand
  BUT threatens unintended consequences

Why UEMP might not stimulate demand

- Generally premised on belief in short-term "Keynesian" stimulus of demand BUT
- Smacks of "panic" and inadequate reflection
- The policy signal might not get through
- Indebted consumers might not spend and
- Corporate investors thus remain cautious
- Just as Keynes himself predicted

But UEMP might have unintended macro effects

- Warnings by Wicksell, Hayek, Koo, Minsky, Shin about real and financial effects
- Non financial debt in G20 has risen 30%
- “Zombie” companies and banks lower productivity and potential
- Imprudent behavior further encouraged
- Asset prices driven to levels like 2007
- Waves of unpredictable RORO trading

Including implications for EME's

- Post crisis, EMEs seen as "safe haven"
- EME's resist upward pressures on currencies
- Thus importing inflation and "imbalances"
- Making them internally vulnerable
- While still exposed to external shocks

With other unwelcome side effects as well

- Worsens income distribution as poor and rich gain at expense of the middle
- A threat to central bank “independence” and
- To the solvency of insurance companies and pension funds
- Governments forebear on other policies to restore sustainable growth
- With growing social and political implications

And might prove very hard to exit

- For some debtors, debt cannot be serviced at "normal" interest rates
- This includes many governments who will pressure central banks to keep rates low
- Central banks also fear a disruptive transition
- Expect financial "repression", use of capital controls and macro prudential instruments
- This could lead to **near term** inflation BUT
- Another deflationary "bust" happens first?

Possible macro end games?

- Stronger growth and orderly tightening
- Stronger growth and disorderly tightening
- Weaker growth reveals that debt and asset prices are unsustainable
- Risks of **near term** inflation or deflation influenced by shifts in potential growth
- Risks of **longer term** hyperinflation influenced by rising government debt levels?

A better way forward than “more of the same”

- Governments with relative room for maneuver should use it.
- Both public and private investment should be encouraged
- Debt forgiveness and restructuring must be used more aggressively
- Structural reforms should support growth and the reduction of international “imbalances”

But there is little likelihood of this happening

- Many impediments to international macroeconomic cooperation
- High debt levels constrain public investment and uncertainty affects "animal spirits"
- Technical and moral impediments to recognizing that "the money is gone"
- Structural reforms are resisted by vested interests and shortages of government money

And history could repeat itself

“What this apprehensive and defensive world needs now, more than ever, are the attributes it seems for the moment to have abandoned– courage and magnanimity”

Sir Arthur Salter

“Politics, politics, politics”

Joseph Schumpeter

GOOD LUCK