

Macroeconomic Policy and Economic Stability: Lessons of the Historical Experience with Fiat Money and the Implications for the Future

Comments by William White on the Presentation by Lord Adair Turner

Introduction

In his recent lecture at the Cass Business School, Lord Turner noted that even mentioning the possibility of overt monetary financing was akin to breaking a taboo. Moreover, in the view of some people, to actually do such a thing would be “a mortal sin, a work of the devil, as much as a technical error”. Against this background, it would seem wholly appropriate that Lord Turner has chosen a meeting of the Institute for New Economic Thinking to give us his further reflections on this topic. In light of the ongoing crisis, members of this Institute should be among those most prepared to question the assumptions and policy prescriptions that we previously took for granted.

Of course whether this is a “New Way of Economic Thinking” or a “Very Old Way of Economic Thinking”, or something else altogether, depends on how you present it. Lord Turner supports the need for an open mind by noting that members of the Chicago School (Milton Friedman and Henry Simons), along with Irving Fisher, suggested back in the 1930’s that government deficits should be financed directly by fiat money. This is true. Nevertheless, I think their motivation and recommendations were in fact quite different from the policy suggestions of Lord Turner.

Dating from Wicksel (at least), the insight that banks create money in the process of making loans has become more widely accepted; in effect, banks simply write up both sides of their balance sheet. This **fact** is what fundamentally distinguishes a monetary economy from a barter economy, and leads to the possibility (indeed, Minsky would have said, the inevitability) that excessive credit creation will lead

to cycles of “boom and bust”. Both Hayek and Keynes recognized this fact. Against this background, the Chicago plan aimed to **prevent** crises by taking away the capacity of private banks to create money. Narrow banking was the very core of their proposal.

In contrast, Lord Turner’s proposal (as described more fully in his Cass lecture) has to do with crisis **management**, with “getting out of this mess”. Moreover, the solution that he wants us (at least) to consider would be further increases in government deficits that would be financed by an increase in base money (technically not debt) rather than more traditional funding. However, since he specifically says he would not abolish fractional reserve banking, the fundamental character of our current banking system would not change. The proposed increase in base money could then serve as the basis for still more private sector debt and leveraging, when the current economy seems to me to demand the very opposite.

Another way to characterize the difference in interpretation is that Simons and Friedman were proposing a **regime** change, while Lord Turner is proposing a **policy** change. Had the proposed regime change been in place, an economic downturn requiring an expanded government deficit and a rising monetary base would have been preceded by an expansionary period of declining deficits and a falling monetary base. Since this was clearly not the case in recent years, I suggest that both Simons and Friedman would have seen more risks than promise in Outright Monetary Financing at this juncture. It is also important to note that, under the Chicago Plan, the increase in base money in bad times would have been temporary and not permanent, as suggested in the Cass lecture. I will come back to this later.

In fact, if I had to emphasize just one aspect of the Chicago plan it would not be linking government finance to the provision of inside money. Rather, it would be the insight that financial structure matters for the performance of the financial system and the economy it supports. The current system we have today allows the utility functions of banks (payments, deposit taking and the provision of loans

to industry) to be threatened by activities that have a real casino quality about them. Four years after the crisis, we still have banks that are too big to fail, and a shadow banking system that is so opaque there is no agreement on either how to define it or measure it. Nor is there any agreement on how these problems might be minimized

This should change in a fundamental way. However, given the magnitude of the public sector subsidies currently given to support the current system (e.g. , lower borrowing costs for SIFI's, as documented by Andy Haldane and others), it is not surprising that financial industry representatives are lobbying hard to keep things essentially the way they are. This can only be dealt with by policies that might seem even more radical than those suggested by Lord Turner.

Crisis Management: What is the problem and what is the solution?

I think Lord Turner correctly identifies the character of the problem we face. It is the necessity (or desire) for the AME's to deleverage after a long credit boom. Moreover, the need for this has been accentuated by twenty years or more of Greenspan "puts" (and the like) leading to what George Soros has called the "supercycle". Further, the need for deleveraging has also been accentuated by the fact that the problem does not just affect a few countries but almost everyone. As a result, and unlike most previous debt crises, individual countries cannot count on growing out of their debt problems on the backs of their neighbours

How did this global problem come about? When the AME's tried to expand through monetary stimulus in the past, their exchange rates should have fallen. However, the EMEs resisted this through outright FX intervention and easier monetary policies than they would otherwise have followed. In short, the problems of the AME's were effectively imported by the EME's, while liquidity created in the EME's worsened the problems of the AME's. Thus, we now have a problem of excessive leverage and dangerous "imbalances" almost everywhere. t the global level. The fact that our International Monetary Non-System allowed

this outcome, indicates that we need to go back to these “systemic” questions with some urgency.

Having established that we are in a “mess”, Lord Turner then considers how various macroeconomic policies might be used to help get us out of this mess. Before turning to his analysis, with which I mostly agree, let me note that the case for “still more” demand stimulus is not watertight. There is more to an economy than just real side demand. First, demand stimulus can get in the way of deleveraging, and the McKinsey Institute reminds us that this process has hardly begun. As of 2011, only three countries (the US, South Korea and Australia) had total debt ratios (public and private) that were lower than they had been on the eve of the crisis. Second, credit related crises often result in distortions on the supply side of the economy which reduce the level of potential. This raises the risk of inflationary pressures reemerging in the wake of still more demand stimulus. The UK could be a portent of things to come, but I will come back to this. Finally, most countries have already done a massive degree of fiscal and monetary easing, and it has not produced “strong, sustainable and balanced growth” as the G20 would like.

My question is whether “still more of the same” might introduce new risks that might actually be greater than the risks associated with just putting up with somewhat slower growth for a while. Or to put it another way, the economy is a highly complex system in which multiple equilibria seem possible, and whose functioning we hardly understand. Is there not then a danger that we will push the economy still further beyond what Axel Leijonhufvud calls the “corridor of stability”, in pursuit of what Hayek would have called “the fatal deceit” of assuming policymakers can fix all our problems, and quickly at that?

I generally agree with Lord Turner in his depiction of the downsides of “pure” (ultra easy) monetary policy”. First, it might not work. Keynes himself came to this conclusion as he progressed from the Treatise to the General Theory. Second, it might have “harmful adverse consequences”. As Lord Turner kindly notes, I have written a paper on this, and I believe that these risks continue to be

underestimated by central banks worldwide. At the moment, my greatest concern is that monetary policies are distorting enormously the functioning of financial markets. The situation today looks to me like 2007 all over again, with a sharp rebound in bond prices being top of my list of worries. This could have important implications for financial stability.

I also agree with his concerns about relying further on “pure” fiscal policy. If financed with more debt, as is currently the case, sovereign rates could rise in a discomfoting way and perhaps even in an unsustainable way. In this regard, my principal concern is that we have no criteria to help us understand when this might happen. Two particular cases make this clear. On the one hand, I find convincing Paul de Grauwe’s argument that a number of peripheral European sovereigns have been victims of a self fulfilling market attack that could not be justified by initial (or even projected) debt levels. On the other hand, a very recent OECD study suggests that Japan, the UK and the US will face the greatest problems in stabilizing their government debt ratios. Implicitly, the policy advice is that they should address this problem urgently. Yet, these are precisely the countries that have the lowest sovereign borrowing costs in the OECD area. As the chairman of the EDRC at the OECD, I note that this absence of criteria is a serious impediment in giving policy advice to member countries.

Well, this brings me to the essence of the paper, that Overt Monetary Financing (OMF) might work better at stimulating demand than either “pure” monetary policy or “pure” fiscal policy on their own. By way of analogy, it is like saying “Soup and sodium – not good. Soup and chlorine - also not good. But, soup and sodium chloride – very tasty”. Frankly, I am skeptical, although likely not as skeptical as Jens Weidman, and would like to raise a few questions just to stimulate discussion.

What precisely is the difference between what is being suggested and what we have already done. While not presented as a coordinated package, fiscal deficits have risen sharply in a number of countries and have, to a very significant degree, been financed by expanding the balance sheet of the central bank. It is perhaps

significant that the various central banks have engaged in Quantitative Easing in quite different ways, indicating that there is no consensus on the best way to do it. Regardless, the bottom line is that the increased supply of base money has been matched by an increase in demand and the broader monetary aggregates have responded little if at all. How might a more coordinated fiscal- monetary package led to a different outcome?

Lord Turner suggests that the essential difference between what has been done, and what is being suggested here is that the infusion of base money will be described as permanent. What is not clear is how this “permanence” will alter the transmission mechanism, not least overcoming the “liquidity trap” in any reasonable time period. One possibility is that the argument rests on a form of rational expectations, but the shortcomings of such assumptions are now well known. Another possibility is that (absent an increase in debt), there will be less of a tendency for sovereign rates to rise due to fears about sustainability. Conversely, might increased deficits financed by monetary expansion not lead to higher inflationary expectations and higher sovereign bond yields?

Finally, if the perception of “permanence” is important in altering the behavior of economic agents, how can the monetary authority credibly commit to such “permanence”. Central banks have repeatedly changed both their objectives and preferred analytical models over the last 30 years, and are in the process of doing so again. Astonishingly, they seem increasingly to be targeting real variables, as in the 1960’s and prior to the insights of Freidman and Phelps. Who then would believe them when they said “Trust me, it’s permanent”.

Another area where I am unclear has to do with the role of inflation and changes in inflationary expectations. Early in his Cass presentation, Lord Turner presents a traditional model in which inflation is driven essentially by the output “gap” and “independent” expectations. In the present juncture, this would likely imply that inflation was not likely to get out of hand any time soon. Yet, a large and permanent addition to the stock of base money would seem to have inflationary implications. Indeed, a number of people would actually seem to welcome such

an outcome since, if unexpected, it would serve to reduce the real burden of sovereign debt. The threat of an inflationary outcome would evidently be increased by worries about fiscal dominance, which would likely be exacerbated by plans of OMF. Were there to be an inflation related shift downward in the demand for base money, and a shift downward in the demand for broader monetary aggregates, this process could proceed very rapidly. Indeed, we have seen it happen many times over the course of the years.

Which brings me to a last puzzle. Lord Turner clearly recognizes inflation could be a problem, and suggests that “apparently permanent OMF could if necessary be reversed or offset by other (macroprudential?) means”. The first alternative raises the possibility that the original monetary infusion was both permanent and temporary. Like Schrodinger’s cat, it is both alive and dead. This is a concept I have always had difficulty with, though physics was never my strong suit. As for macroprudential measures, our knowledge of how well they work is in its infancy. It would be a big gamble to put too much faith in them to offset a monetary induced wave of inflation, to say nothing of all the other imbalances that might naturally arise in such circumstances.

My comments thus far might seem to indicate I am pretty pessimistic about getting out of “this mess”. That is not quite right. I am just concerned about an over reliance on macroeconomic stimulus to do so, fearing that it might do more harm than good. Rather, I would use a blend of policies, both demand and supply, chosen to reflect the special circumstances of a credit driven recession. I am, however, under no illusions when it comes to the political acceptability of some (all?) of these suggestions.

First, we need much more international cooperation on macro stimulus. Those countries in the best position to do it, should do it. Countries with large current account surpluses have more room for maneuver than others. Exchange rate changes are part of the process of adjustment.

Second, we need more public and private investment. For the former, markets must be convinced that any increase in government liabilities comes with an

increase in a productive asset. For the latter, we must try to create a more business friendly environment, not least with some of the uncertainties removed about the incidence of future tax burdens.

Third, we need explicit debt reduction on the part of ultimate borrowers, probably recapitalization (or closure) of the banks that lent to them, and in some cases international support for sovereigns who have themselves become over extended. Where sovereigns do have some room to increase debt, the case for using this room to stabilize the banking system (rather than direct spending or tax cuts) should be strongly considered (as suggested by my old BIS colleague, Claudio Borio).

Fourth, we need structural reforms to raise the potential for growth and to reduce the burden of debt service. There are many “low hanging fruit” waiting to be picked.

Crisis Prevention: The need for a new mindset

I agree with Lord Turner that we need to “lean against the wind” of the next credit cycle. I am not sure what instruments he would use to do so, but I would suggest the joint use of monetary and macroprudential instruments. Each has advantages and shortcomings, likely with a different balance in different countries, which makes the use of some combination of instruments seem more plausible. As I said before, we are in uncharted territory here.

As for the Simons/Friedman proposals, they come down to a rule for the rate of growth of the money stock which would “ensure” price stability. The problem with this assertion is that it depends on the assumption of a stable demand function for money (the “V” in $MV=PT$), which experience shows is far from being the case. As Gerry Bouey, my old boss at the Bank of Canada put it, after we gave up our monetarist experiment of the late 1970’s, “We didn’t abandon the monetary aggregates, they abandoned us”. Moreover with the spectacular increase in the size of the shadow banking system, I suspect the problem of monetary instability has become even worse.

I would finally make a broader point. During the whole post War period, we have tended to follow highly activist macroeconomic policies (first fiscal and then monetary) with that activism much more apparent in resisting downturns than upturns – in short, a highly asymmetric set of macroeconomic policies. The upshot has been a gradual ratcheting down of policy rates to essentially zero, and a gradual ratcheting up of government debt to levels that look increasingly unsustainable.

To avoid big crises in the future, we must become more willing to accept minor downturns, mini crises, and the occasional failure of a financial institution. Again, I am under no illusions as to how politically acceptable this might be in a world dominated by “short term” objectives and the belief that “something must be done”. Nevertheless, I continue to believe that this approach provides the surest means of fighting the accumulation of moral hazard and bad behavior that has led us to our current and still precarious situation.

.. Yet later on, in all this. s