OECD Observer

False beliefs and unhappy endings

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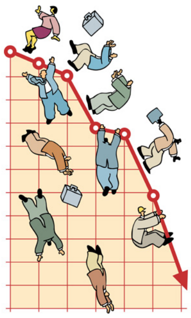
Last update: 9 February 2016



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Could central bank policy be making the economy more vulnerable? A fundamental rethink is in order if worse outcomes are to be avoided.

Central banks in the major advanced economies have been pursuing unusually lax monetary policies for many years. Moreover, the ways in which they have done this have become increasingly experimental. These expansionary policies bear the risk of ending unhappily. In large part, this single-minded pursuit has reflected the political reality that monetary policy has become "the only game in town". Yet in no small measure, it also reflects some long-held but false beliefs about how the economy actually works. Moreover, absent any discipline imposed by an international monetary system, virtually every central bank in the world became engaged in a process of unprecedented monetary easing–the so-called "currency wars". As a result, the global economy could now be even more vulnerable than it was in 2007.

The fundamental problem is that modern macroeconomics is based upon a false belief: namely, that the workings of the economy can be understood and therefore closely controlled, as though a machine in the competent hands of its operator. A philosopher would say that we have made a profound ontological error. We have failed to realise that what one can know about a system depends upon its very nature. And the nature of our economies is simply too complex to be understood, much less controlled.

Consider that the analytical frameworks generally accepted by central banks totally failed to see the crisis coming or, despite concerted and persistent action, the weakness of the subsequent recovery. That alone should have been sufficient to raise some fundamental analytical questions. Moreover, support for scepticism is provided by reviewing the actual practice of monetary policy over the last 50 years. Every aspect of it–including its objectives, instruments and indicators–¬has been subject to repeated change. Generally these changes have been in response to previous policies failing to deliver the intended results, or producing unintended and unwarranted side effects. In short, monetary policy has systematically got it wrong. There would then be nothing unwarranted about another fundamental rethink in response to recent events.

One approach with promise is to think of the economy not as a machine, but as "a complex adaptive system" with millions of interactive and adaptive agents following simple behavioural rules. Such systems characterise car traffic, movements of crowds, the spread of crime and disease, social networks, etc. These kinds of systems are everywhere in both nature and society, and exhibit recurrent instability and highly nonlinear outcomes. Does it make sense to assume that the economy, with all its flows and myriad interactions, should almost uniquely fail to exhibit these traits?

Clearly not. In fact, complex adaptive systems share key properties that have been well studied by other disciplines and could inform economic policy makers. First, they regularly break down, so be prepared. Second, the particular cause is irrelevant, so focus on systemic instability. Third, we lack the knowledge to optimise, so focus on avoiding truly bad outcomes. Fourth, the system is adaptive, so move forward and avoid the temptation of fighting the last war. In sum, policy makers should be much more humble in their aspirations.

When the crisis struck, the consensus was to continue to pursue monetary stimulus, but in increasingly novel ways. Yet to date, the rethinking of previous beliefs by central bankers has fallen well short of a needed "paradigm shift". We remain very much in a "muddling through" mode, with no real appetite for fundamentally reforming our current fiat money system, domestically or internationally, or for questioning the merits of using "still more easy money" to deal with a solvency rather than an illiquidity problem.

Why is this so? Back in the 1960s, scientist and philosopher Thomas Kuhn pointed out that "paradigm shifts" are hard to achieve even in normal times. Intellectual capital built up over whole lifetimes is not easily jettisoned. For policy makers it is even more difficult, since raising questions implies the possibility, or even the outright admission, of previous policy errors. More recently, Daniel Kahneman, a psychologist, has noted that major events, which deliver a shock to current beliefs–effectively non-normal times–typically result in a retreat into those beliefs rather than a fundamental rethinking of them. Given their respective histories, Germany will be forever fearful of government deficits and hyperinflation, while the US will always resist rising unemployment and a deflationary spiral.

In the absence of a paradigm shift about how the economy works and how it should be managed, monetary policy since 2007 has essentially been "more of the same". It assumes that easy money will eventually stimulate aggregate demand and that any unintended consequences can be ignored. Unfortunately, both of these propositions are extremely doubtful. Interestingly, John Maynard Keynes expressed strong doubts about the former proposition, while Frederic Hayek, and also Hyman Minsky, expressed strong doubts about the latter.

While recognising the great contribution of central banks to restoring financial stability early in the crisis, there are good reasons for doubting that monetary policy will prove effective in stimulating global aggregate demand over time. Much of what has been done smells of panic. By increasing uncertainty, policy actions might even have encouraged both households and corporations in the advanced economies to hunker down and spend less. Moreover, what is more certain is that, when monetary policy does work, it does so in large part by encouraging people to bring their spending forward in time. However, inciting people to spend by taking on higher levels of debt simply cannot go on forever. Could we now be approaching payback time?

It is simply a fact that global (non-financial) debt levels, relative to GDP, have been rising since the early 1980s and this trend has continued since the onset of the crisis in 2007. Far from being a time of deleveraging, the leveraging has continued. Worse, while the advanced market economies have shown a degree of moderation, the emerging market economies have sharply increased their debt levels. In particular, corporations in emerging markets have borrowed heavily in international bond markets, and largely in US dollars, which continue to rise. Emerging markets may have been part of the solution in 2007, but they are now part of the problem.

Easy monetary policies not only are unlikely to achieve their desired objectives, but their unintended consequences are becoming increasingly evident, too. There are sharp declines in productivity growth almost everywhere, along with a slowdown in the formation of new businesses. It is not implausible that easy money has encouraged the "ever-greening" of zombie companies by "zombie banks". Moreover, the prices of almost all assets, whether financial or in property, have been bid up in many countries to levels that heighten the prospect of severe future losses. Who will suffer and what might be the systemic implications? We simply do not know. Monetary policy has led us into truly unchartered territory.

What we do know is that the health of many financial institutions is now under threat. Bank profits, needed for capital accumulation, are being reduced by low credit and term spreads. Pension funds and insurance companies are threatened even more. Everywhere, there is the temptation to "gamble for resurrection", again with unknown consequences.

The great American journalist HL Mencken once said, “there is always a solution to every human problem–neat, plausible and wrong”. We need to ask ourselves whether easy money is really the solution to the problem of ensuring the “strong, sustained and balanced growth” that we all desire. Or is this simply a false belief that threatens an unhappy ending? If so, it desperately needs to be rethought.

References

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