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William White: "Financial Markets Could Get a Terrible Reckoning"

William White, former chief economist of the Bank for International Settlements, sees several reasons why structural inflationary pressures remain high – and why central banks face an almost insurmountable task.

Mark Dittli (md) | February 23, 2023 Deutsche Version

William White is used to warning the powerful in the financial world - and being ignored by them. The Canadian has worked for central banks for almost fifty years, most recently for the Bank for International Settlements (BIS) in Basel, where he was chief economist until 2008. He was among the few voices warning of the financial crisis at the time.

White does not think much of the hope currently prevailing in the markets that inflation will quickly evaporate. A series of supply and demand shocks suggest that structural inflationary pressures remain high. "Interest rates would have to rise," White says in an in-depth interview with The Market NZZ, but the big question is whether central banks could allow that to happen at all.

The stakes are high, he warns. "What if all of a sudden citizens become convinced that the government is not delivering on its promises? Where does that lead in terms of democracy and faith in the system? These are dangerous things. We have to get this right."

There seems to be an optimistic feeling currently that inflation is coming down rapidly while the major economies will avoid a recession. What's your take?

You know me, I'm always looking at the dark side. Sadly, most of what I have been worried about has come to pass. Today, I think that markets are far too optimistic about disinflation: Certainly what we are seeing is that the worst aspects of the supply constraints seen during the pandemic are winding off. Goods and transportation prices have come down a lot. But when you look through that, it's hard to see how you can get further disinflation everywhere without some kind of a real demand side impetus.

You mean a recession?

You need something like a recession or a sharp slowdown in profitability, one or the other, to get further disinflation. I just don't see how to get back to 2% without any kind of real demand side destruction to force it to happen. There is a presumption for an immaculate disinflation, without messy side effects. I can understand the hope for this, people want to have a nice, soft landing, with no price to pay. After so many years of low inflation rates, people may think that this is the normal state of things. But hope doesn't mean it's going to happen. I worry that a number of inflationary forces will remain in place for a long time.

Which forces are these?

We can distinguish between supply shocks from past policy and future supply shocks. First, we can establish that there was an excess stimulus of demand during the pandemic, and the system is still working through that. Plus, all downturns have hysteretic effects on supply, you never totally recover. And I think the Covid pandemic has the potential to leave even more scarring, especially in the workforce. In the short term, we have the issue of the reopening of China, and we can't say yet what the implications of that will be. On the one hand, you can say China is back in terms of production, but I think what's more likely is that China is back in terms of more consumption, particularly for commodities. The other thing that worries me about supply side problems from the past is the gigantic resource misallocation that was associated with easy money over such a long time period: There are oodles of unprofitable companies, zombies, kept alive by easy money. These zombies tended to keep prices down because of extra production capacity, but now with tightening monetary policy, many zombies will get wrung out of the system. Those are the supply shocks from the past. More important are the ones that lie ahead, though.

Walk us through them.

In terms of future supply shocks, you could point to at least four things: The labor force, climate change, commodities, and problems to do with a decoupling of production. As to the labor force, Charles Goodhart and Manoj Pradhan wrote an excellent book on the demographic reversal. The world economy has seen a tremendous demographic boost with the baby boomers, the return of China, and the fall of the Soviet Union. But now it's all going into reverse. I'm sure you read a few weeks ago that China's population has declined for the first time in decades. Japan has been on this slope for years, so have Korea and most Western countries. The baby boomers are retiring, except old cookies like myself who refuse to withdraw from the frame. From an abundance of workers we are facing a shortage of workers.

What's with the second supply shock, climate change?

The climate change thing I think is underestimated. This could be an existential threat to humanity, and yet somehow economists are not picking this up and factoring it into their forecasts. There are basically two ways to deal with climate change: mitigation or adaptation. The thing is that both ways are very costly. Mitigation requires the stranding of previously available fossil fuels. The initial manifestation of course is that energy prices have gone way up, because the supply of renewables has not yet increased to the point where it could totally replace fossil fuels, while the demand for energy has not come down. And what exactly does adaptation mean? It means more extreme weather, hurricanes, ports being blown away, all of that stuff. So any way you turn it, dealing with climate change will be costly.

And the third supply shock, commodities?

That one is closely related to the climate change theme. We tend to think that the Russian invasion of Ukraine is what drove prices up. But energy prices were heading north well before that. Longer term, energy will be in short supply for quite some time. Probably the most important field is metals. To achieve the electric transformation, we're moving from a world that was fossil fuel based to a world that is going to be metals based. Lithium, cobalt, copper, all of that. It takes ten years from the time you discover a deep mine, before you get production. You can see the upward pressure on all that stuff as well.

That leaves supply shock number four, decoupling.

This is kind of a self-inflicted injury, but the threat of decoupling between China and the US is real. I recently attended a meeting involving lots of people from the national security establishment. What I took away from that meeting was that, in the US in particular, a lot of legislation is being passed encouraging decoupling from China, but without any significant investigation into the economic costs of doing this. As you think about how the global supply system has evolved over the course of the past three decades, each little part ended up being made by the most efficient producer of that part. How are you going to get out of this system, diversifying it, when the whole trend has been towards consolidation? We should not underestimate the systemic difficulties and the costs associated with that.

So all in all, you would say that there might be a period of disinflation now, but inflation will settle at a higher level?

It's impossible to say with precision. Inflation is on the right path at the moment, but yes, I think it will prove much stickier. It could go down to 2% and stay there for a while. But these other forces are out there, and they will manifest themselves in the fullness of time. The course of the next few years is going to be a rocky path.

Are we looking at a repeat of the «stop and go» inflation of the Seventies?

I think it's different. In the Seventies, we had a shock in energy prices, but there was an element of self-correction embedded into that. When people had to pay more for energy, they had less money to spend on other things. But here it's a bit of a different story, because a lot of the things I have just mentioned, the character of the supply shocks, cry out for more capital investment. If you don't have enough workers, you need to invest into more capital equipment.

But wouldn't more investment also lead to more production, which would alleviate the supply shocks?

Yes, in the longer run that's true, but in the near term it means more demand. Now continue down my list: Climate change, both mitigation and adaptation, means more investment. Electric transformation means more metals, and more metals means more investment. Then you have to add the fact that given geopolitical tensions, everybody will get sucked into more military spending. So not only are we going to see negative supply shocks, but at the same time we'll have positive demand shocks. You put the two together, it seems to me it's a recipe for higher inflation and higher real interest rates.

Is there much central banks can do to fight this kind of inflationary pressure?

If the world unfolds in the way that I suggest, the important point is that we should have higher real interest rates than in the recent past. But to get real rates up, nominal rates need to go up even more than the rate of inflation. The question is whether central banks will allow that to happen or not.

Why not?

What I see lying ahead are two impediments to central banks being willing to allow rates to move up the amount that they should: The potential for financial system instability and the potential for fiscal instability. On the financial instability side, there are just so many indicators that tell us that the system is fragile. We've had ultra easy money for decades, which in a nutshell has encouraged people to take out debt to do dumb things. If you look at aggregate debt numbers of corporates, households and governments, debt ratios have been going up and up and up. As per the Institute of International Finance, total debt to world GDP was 250% in 2008, and then it went to about 320% just before the pandemic, and subsequently peaked at about 360%. These are numbers that we have never seen before in peacetime. On top of this, there has been a decade-long deterioration of the quality of this debt. Closely related, a fascinating recent study by the McKinsey Global Institute showed that up until about the year 2000, broad measures of wealth basically tracked income or GDP. But since then, there's been a huge discrepancy, with wealth rising much faster than GDP. But if the production hasn't gone up, while the wealth has, the conclusion you can come to is that it's not really wealth. It was merely a rise in the prices measuring that wealth. I wrote a rather prescient paper about this, at the BIS in 2006, called «Real Wealth, Measured Wealth and the Illusion of Saving».

So you're saying that given the inflationary pressures, real interest rates should rise, yet at the same time, given the fragilities in the financial system and given the levels of debt, the system cannot stand higher rates?

Yes. And I suspect, although I do not know, that this is one of the reasons that central banks had been so hesitant until last year to raise rates. That's basically the story that I'm telling: We have a more inflationary future coming, so real rates should rise, that means nominal rates should rise probably quite significantly, and that one of the worries central banks have is that they could cause instability in the financial system. Then of course they get blamed for it. Central bankers are human. Well, most of them are, anyway.

Isn't the system much more robust today compared to 2008, when the Global Financial Crisis hit?

I don't know, is it? There was an article in the [Financial Times on 14 December 2022](), by Tom Hoenig, the former President of the Kansas City Fed. He's a very sensible guy, and he was saying that with some of the recent changes in regulatory rulings in the US, that the tangible capital ratios of the eight largest banks were now back to where they were pre-GFC. So the banks may be well enough capitalized, maybe not. The other important thing was a massive movement out of bank credit into credit extended elsewhere; non-bank financial institutions, leveraged loans, private debt, you name it. Non-bank financial institutions are now bigger than the regulated banks, and we don't have the transparency and information to know what's going on there in terms of systemic risks. Don't forget that the economy and financial markets are what I call complex, adaptive systems. They don't follow linear, deterministic paths. There are tipping points. These systems can be stable for a long period of time, and then suddenly become unstable. One more thing I need to mention on the topic of financial instability is that we see repeated examples of malfunctioning markets.

Like the episode we had in the UK with the Gilts market in September 2022?

Absolutely. Badly designed, unfunded tax cuts by the Truss government interacted with the derivatives market in a way that almost blew up the pension fund system. Mind you, it was not that it was totally unexpected, because apparently the UK regulators had conducted stress tests about whether these pension funds had enough liquidity to meet margin calls given the character of their investment – and the conclusion was that they did. But what they missed was the magnitude of the movement in the price of Gilts. It moved well beyond what they had assumed as the maximum in the stress test. In the past years, we've also had flash crashes and sustained pricing anomalies here and there. Even the US Treasury market has repeatedly been under stress. If Treasuries behave badly, all the global markets dependent on it might end up behaving badly.

The Bank of England swiftly stopped the panic, didn't it?

Yes, but the central point with the Gilts shock was that it was this interaction, that something moved beyond a trigger point and stuff began to happen elsewhere, that forced the BoE to step in. They had to step in and expand their balance sheet at exactly the time they had actually committed to shrinking their balance sheet. This seemed proof to some that financial stability concerns will trump concerns about price stability. It planted a seed of doubt into people's minds; central banks may commit to something, but will they deliver?

What if the bond market just forces an upward move in nominal interest rates?

That could happen. All of a sudden markets could get a terrible reckoning when they realize that the underlying inflationary pressures are much stronger than they anticipated. But then that brings you back to the Gilt market: What happens when we get a repricing, greater than what people anticipated? Where will the fallout be? The answer is we don't know. This worries me. And then once again it will be up to central banks to rescue the financial system. Moreover, at some point, markets will start to question not only financial stability but also the fiscal stability of governments.

That would be your second impediment that could prevent central banks from doing what they have to do?

Yes. Again, back to the Gilts shock: The thing that set it all off was a reaction by financial markets to these unfunded tax cuts. It had struck the markets as just being imprudent, not just in substance, but also in style. And so the Gilts market exploded. And that is a worry in itself, because it basically says that markets thought that a major country was flirting with debt unsustainability. Remember that wonderful line by the former BoE Governor Mark Carney about the UK trade deficit, that the UK was living on the kindness of strangers? That's the way it's been on the fiscal side, too. Markets give you the benefit of the doubt, but that doesn't mean that they give it to you forever.

How do you mean that?

There was a time where prudent fiscal policy meant that you paid down government debt in good times, so that you had deep pockets when a war came or something. Governments don't do that anymore. As long as they think they can refinance, then that's good enough. But when you look at the fiscal positions, including all the intergenerational liabilities, we all know that many states have been technically insolvent for years already. Interest rates have been ratcheting down for decades, while government debt has been ratcheting up for decades. We're all living on the kindness of strangers. So even though fiscal sustainability does not currently seem to be on the agenda of the markets, that doesn't mean it never will be. When you look back in history on how you get big inflations, it always begins on the fiscal side. The tricky point arrives when a rise in interest rates feeds into the debt servicing cost of the state and starts to cast even more doubts on fiscal sustainability and the capacity to resist inflation.

Which again means that even though central banks should allow for higher interest rates, the system cannot bear it?

Exactly, as was pointed out by Sargent and Wallace in a seminal paper in 1981, titled «Some Unpleasant Monetarist Arithmetic». So you have a world in which policy makers are in a bind: If the fiscal situation is bad enough, and if the central bank doesn't let interest rates go up, then they lose inflation credibility. But if they do let interest rates go up, and it feeds back into the government deficit, then they risk losing their credibility as well. This all is not made easier by the optics of an ever deeper muddling of monetary and fiscal policy.

In what way?

Since the GFC, the increase in the size of central banks balance sheets has been roughly the same as the increase in the government debt stock. So there is your prima facie case of print it and spend it! Now of course it wasn't done with that explicit aim, it just sort of happened, but the optics of it are bad. The other thing that worries me is the optics of central banks starting to lose so much money as a consequence of their policy. Of course, they have to make sure the system functions, I totally agree with it, but still, it adds an element to the bad optics. The Federal Reserve is a trillion dollars under water. Even in Switzerland, last year's loss by the Swiss National Bank, in market value terms, added up to 18% of Swiss GDP. Now you guys have been prudent at the fiscal level, so this will not derail people's expectations about a prudent future of Switzerland's financial situation. But for a lot of other people the worry is that this is the poison icing on the already poisoned cake.

So in a nutshell, you are saying that given the structural inflationary pressures that lie ahead, interest rates ought to go higher, but there are significant concerns about both fiscal stability and financial system stability if they do go higher?

Exactly.

What gives?

In a way, there are only hard choices left, but there is still the lure of easy options. Over the past years the easy option was always to push the previous strategy a bit further. The problem is that the prevailing macro framework behind that thinking is essentially a kind of linear deterministic thinking. It has worked in the past, so it will work again. But to those of us who believe that the world is non-linear, there is always the possibility of the straw that breaks the camel's back. I often use a joke to illustrate this, about the guy who jumps from the 20th story window, and as he passes the window of the second floor, someone asks him: How are you doing? And the guy replies: So far, so good! The next thing to watch out for, in my view, is this policy of yield curve control in Japan. They've kept rates down for such a long time, what if all of a sudden markets really do press in and force rates to rise? What does that mean for government debt service? Also, if all of a sudden Japanese investors all start to head back home because the yields are higher in Yen, there will be huge implications worldwide. It will be a litmus test in a sense.

Your critics would say that you have been warning about this forever, and yet policy makers always found a way to muddle through.

Absolutely, you know me, I've been worrying forever. I have questioned for years their capacity to do it one more time. And yet again and again, they managed to do it one more time.

What makes you think they have reached the end of the rope now?

I think now, perhaps for the first time, markets are becoming concerned about the sustainability of the fiscal finances of large, advanced countries. But granted, it may be just rationalization on my part, saying that this time is different. All I do know is that each time you do have another crisis, it gets more difficult to crawl out of it. This whole kicking the can down the road thing, as the problem becomes more difficult, the solutions you have to offer become less effective.

What is the most probable way to get out of this bind of fragile fiscal stability and the need for higher interest rates?

I think the answer, not the best answer but the most likely, might well be an attempt at financial repression. Governments can keep interest rates down by forcing investors to own their bonds. This is what happened after World War II, both in the US and the UK. You pass laws that force investors to hold your debt, and at the same time you allow inflation to go up to a level that is just tolerable, say, a level of 5 to 7%, thereby allowing nominal growth to be significantly higher than interest rates. That way, after a number of years, the debt problem will have magically gone away. I'm not sure though if and how this would work in today's world of much freer capital markets. And even if it can and does work, it has a cost because inflation is a tax. Many people who thought they had wealth will realize that a sizable part of it was just an illusion of wealth.

What else could policy makers do?

Orderly processes to restructure debt. Prudent fiscal policy. Given the need for higher investment expenditures, lower private consumption could square the circle. But of course this will be very unpopular among consumers. In terms of taxes, I see a need for higher taxes for energy and higher taxes for property. More targeting in government expenditures, targeting the more vulnerable. That of course means the less vulnerable will have to pay for that. That's what a humane society has to work out. But you know, we really have to get this right. Because what if all of a sudden citizens become convinced that the government is not delivering on its promises? Where does that lead in terms of democracy and faith in the system? The system screwed me, so screw you? These are dangerous things. My worry is that citizens, the powerful and politicians will again choose the easy answer: Continue to just spend and print. That would be denial. We have to get this right.

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. He has published widely on topics related to monetary and financial stability.