10 Years after the failure of Lehman Brothers:

What have we learned?

Panel Comments by William White

14 September, 2018, OECD, Paris

I was asked to comment on Maury Obstfeld's presentation. However, since I have been given only a little over five minutes to do so, and this is the last panel of the conference, let me rather use the time to make some more general comments that tie together the discussions of both yesterday and today. I will circulate some more detailed comments on Maury's paper later, though it suffices to say now that I agreed with almost all of it.

I begin by asserting that there were at least six beliefs, widely held before the crisis, that I would personally classify as "false beliefs".

First, domestic price stability is sufficient to ensure macroeconomic stability.

Second, financial developments (especially involving stocks) are not a significant threat to macroeconomic stability .

Third, floating exchange rates will suffice to deal with current account imbalances

Fourth, given floating exchange rates, international "spillovers" from domestic monetary policies (especially those of the US) are unimportant.

Fifth, if domestic price stability and floating rule out future crises, then we do not need to prepare for them.

Sixth, to the limited extent the mainstream thought about distributional issues at all, growing inequality was thought to be a price worth paying to get faster economic growth.

I would contend that a measure of "What have we learned ?" is the extent to which we now have some agreement that these pre-crisis beliefs were in fact not true. If we accept this criteria, than Maury's presentation indicates that we have learned a great deal. He notes explicitly that financial developments are central to macroeconomic outcomes. He accepts the reality of international spillovers and the possibility that macroprudential policies might be needed to supplement more conventional ones. Moreover, he adds that positive feedback effects in stressful situations can lead to very bad outcomes indeed. Finally, he turns to distributional issues by noting that bad economic outcomes can have undesired political implications. In sum, Maury's presentation challenges virtually all the false beliefs just described above. Allied with some of the recent comments by Jay Powell, the new Chair of the Federal Reserve Board, we have grounds for belief that something fundamental is changing.

However, it would go too far to conclude that a paradigm shift of Kuhnian proportions had already taken place in mainstream thinking. Unfortunately, as Michael Jacobs stressed yesterday, such a shift requires not only rejection of old beliefs but acceptance of new ones. Further, it needs a willingness actually to implement the policies they imply. This we have not seen. Ultra-easy monetary policy in the post-crisis period has essentially been "more of the same". While unconventional in many ways, it continues to be based on the twin assumptions that it will be effective in stimulating aggregate demand, and that any undesirable side effects (like more debt accumulation) can be ignored as unimportant. Both of these assumptions are false. As for financial regulation, this too has been "more of the same". Just as regulatory policies were eased, perversely, as the boom expanded, they have been tightened during the ensuing bust. In sum, we remain well short of the paradigm shift in thinking that I feel is needed.

Perhaps the sticking point has been the perception that there is not a new analytical framework to replace the one that has demonstrably failed us. I want to suggest, consistent with the NAEC narrative from yesterday, that in fact we do have such a framework. By starting from the recognition that the economy is a complex, adaptive system, like a myriad of others in both nature and society, economists can learn many useful lessons from other disciplines that have studied such systems. Ironically, embracing complexity leads to some remarkably simple policy conclusions.

Systems of this sort break down systematically according to a Power Law. The lesson is, be prepared. Given this Power Law distribution, really bad things not only can happen but will happen. The lesson is to focus on avoiding such outcomes (minimax) even if there is a cost in terms of efficiency. This implies giving more attention to system design and building in both sustainability (avoiding bad outcomes) and resilience (capacity to recover) when bad outcomes do occur. Evidently, a focus on system design goes well beyond the current mantra of simply reducing the damage from market failures. A third lesson is that identifying triggers for crises is less important (though not unimportant) than identifying indicators of systemic stress and trying to respond to them. Finally, systems can break down in different ways at different times. The lesson is, do not fight the last war.

Selling this new framework to practicing economists is the essential effort required in getting a paradigm shift in policy thinking. Sadly, the fact that it has not happened to date, and that we have followed “more of the same” macro policies over the last decade, implies to me that we are likely on the verge of an even more serious global crisis than the one that began in 2007. Moreover, our arsenal of traditional macroeconomic policies to resist such an event is now greatly depleted. The good news is that such a dire environment might provide fertile ground for new economic thinking that could help prevent future crises. The bad news is that such a downturn could possibly have huge economic and political costs. The principal task of policymakers now should be taking steps (ex ante) to help manage better such a prospective outturn.