## Transcript

00:00:01 Dr Oliver Hartwich

Hello and welcome to the New Zealand Initiatives podcast. My name is Oliver Hartwich, and today we are joined by two guests, two economists and the good thing is that neither of them needs any introduction to our listeners because they're well-known economists, in a New Zealand context. I welcome my colleague, Doctor Bryce Wilkinson, and a very special guest, the former governor of the Reserve Bank of New Zealand, Graeme Wheeler. Welcome to you both.

00:00:25 Graeme Wheeler

Well, thank you very much Oliver. It's great to be here.

00:00:28 Bryce Wilkinson

Thank you, Oliver.

00:00:30 Dr Oliver Hartwich

We've invited you onto the podcast because you have jointly written a paper which the Initiative is releasing this week.

It's called *How central bank mistakes after 2019 lead to inflation*. We should probably clarify this is a paper not about the Reserve Bank of New Zealand, or at least not purely. It's about monetary policy worldwide. You're looking at the world of monetary policy, and you're asking what has gone wrong. And that leads me to my first question. I'm going to look at you Graeme, you must be so pleased not to be in charge these days because you were governor right after the GFC and before COVID on the current troubles hit us. So, these were basically the golden days of New Zealand monetary policy. Would you rather like to be in charge today?

00:01:15 Graeme Wheeler

I was there during a pretty interesting period because there were some global shocks. But we did have five years on average of 3% growth and 3% employment growth. The challenge that we had or one of the challenges was inflation was around 1¼ to 1½ percent on average over time. But being a central banker is both challenging and stimulating because you're dealing with all the complexities of an economy, particularly operating in a global world where there's vast ranges of shocks and disturbances. And it's also a role where you're given enormous responsibility because the consequences of policy mistakes are enormous because your decisions can affect the standard of living of people. It can affect employment, it can affect income business failures. It can affect the price of assets and the impact when you get decisions wrong is usually greatest on the most vulnerable people in society. Those that are self-employed or running small businesses or those on the lowest income, so I thoroughly loved the stimulus of the role in the intellectual challenges and working with very dedicated colleagues, but I don't miss the stress about wondering. Have you got the right decisions?

00:02:39 Dr Oliver Hartwich

I imagine. And this concern for people lives for the well-being of the economy was that also what triggered your joint paper, Bryce?

00:02:48 Bryce Wilkinson

Yes, and it's a follow up to the paper the Initiative published last year on *Walking the pathway to the next global financial crash* and times moved on and we've got the inflation scenario and had the dilemmas the central banks have found themselves into. Firstly, they thought there wasn't going to be inflation, and secondly, they thought it was temporary and now they're up with their backs against the wall with a very difficult problem.

So, this paper is very timely and we're delighted to be able to collaborate with someone of Graeme's standing in it.

00:03:25 Dr Oliver Hartwich

And we should probably explain to our listeners that you have a long-shared history in economic policy. You've known each other for, I believe, 45 years, something like that.

00:03:33 Bryce Wilkinson

That probably would be close to that. Yes, we were both in Treasury together in the early 1980s in the macroeconomic side.

00:03:41 Dr Oliver Hartwich

Is that where you first met.

00:03:43 Graeme Wheeler

Yes, Bryce was my boss and and I'm still learning from him, so he's a great colleague to work with.

00:03:49 Dr Oliver Hartwich

Well, that's great actually. After all these years, writing a paper together. Now let's get into the issues that you're dealing with. When you're looking at the world of monetary policy today. I mean, obviously we all see inflation. We all feel the effect of price rises. Is that something that surprised you when it started happening, probably about a year ago?

00:04:10 Graeme Wheeler

Well, not really to be honest, because I had been on record with a number of colleagues about the concerns I had about quantitative easing and why were central banks providing so much stimulus when the fiscal authorities were already providing massive fiscal stimulus. And we started to see the effects very quickly in the housing market. We saw it in terms of compression of yields in the market, and given that you have a supply curve, an aggregate supply curve that's relatively steep, and you've got all this fiscal stimulus, then to me it was inevitable that inflation would start to increase in product markets. And that's what we've seen.

00:04:52 Dr Oliver Hartwich

But for a long time, despite similar stimulus, inflation didn't take off for a long time. We had this great moderation. OK, we had price increases, but in asset prices of course, but not in consumer prices. So, did that surprise you?

00:05:07 Graeme Wheeler

Well, there were a lot of... There are a lot of supply side factors linked to globalization that were pulling down inflation.

I mean the fact that IT prices were falling. that capital goods prices were falling.

That there was a global oversupply of manufactured goods coming out of China.

I mean, when I was governor during the five-year period, we had a situation where inflation in the non-tradeable sector was growing at about 3½ per cent and that's why we increased interest rates at one point in time and that was what we underestimated was the strength, or the weakness I should put it really, of global prices on the traded good sector. And so that's what kept inflation low in many of these economies.

00:05:57 Dr Oliver Hartwich

Yeah, and adding hundreds of millions of people and productive capacity to the world's economy.

00:06:02 Graeme Wheeler

Yes, I mean you've had a massive increase in employment and labor markets coming out of Asia, especially China.

00:06:10 Dr Oliver Hartwich

Bryce, I know it didn't surprise you that inflation at some stage kicked off, but we had discussions in the office about a year ago, a bit longer perhaps, and some of our colleagues said, well, actually you're a bit too gloomy. You and me especially. And they pointed out that markets simply hadn't priced any of this inflation and it simply didn't occur anywhere. Did the markets actually miss something that we saw?

00:06:34 Bryce Wilkinson

What was unnerving I think for me is that markets were pricing on the basis that central banks and governments would sustain extraordinary high asset prices, so you and I, Oliver were quite unnerved that at a time of big unemployment, economic downturn with COVID, with lockdowns, redundancies and bankruptcies actually reduced. And asset prices, S&P 500 Index for example hit record highs and we thought this is a pathology.

I found that I was surprised that we didn't get more inflation prior to 2020, and the puzzle was Japan. that Japan had managed to build up public debt and so much and not had inflation broken out but I think Graeme's put his finger on it that the world was going through a period of globalization where inflation and non-traded goods was very, very low and the other thing I found was grotesque was I think the inflation range of getting inflation up to two percent.  Two per cent was too high for that period, and we had the grotesque situation of central banks, which had put economies through the ringer in the 1980s to weed inflation expectations down. We're now in this situation because this inflation target of having to try and get inflation up and I just never believed that inflation expectations are that controllable.

You played with him at your peril, that was like a child trying to play with fire, and that's what we're seeing now that they talked inflation up and it wasn't controllable enough. And it's got away on them.

00:08:20 Dr Oliver Hartwich

That's almost a philosophical question really, how good markets are at foreseeing the future? I mean, when we go back through the last two decades when markets didn't really see the GFC coming, they didn't see the European debt crisis coming.

The ratings agencies they still gave AAs and AAAs to companies that a few weeks later disappeared. So how good are markets actually anticipating where things like inflation are headed?

00:08:48 Graeme Wheeler

Well, it's interesting, isn't it? Because we all studied efficient market theory and how to price assets and particularly how to price risk. But financial markets are significantly influenced by Central bank forecasts.

Particularly if they believe that that Central Bank is committed to price stability and can deliver price stability.

But you're also conscious that there's a lot of herd behavior and financial markets, and I recall the situation with Argentina because I was studying it quite a lot in the World Bank. It had defaulted 9 times since it gained independence in around 1815 from memory. And yet bondholders continued to acquire Argentinian bonds, and I'll give an example. In 2017 I was quite surprised to see Argentina issue 100 year bond for two and three quarter billion U.S. dollars and the yield was I think just below 8%. Now that bond was more than three times oversubscribed to a country that had defaulted 9 times.

Now that inevitably, I think almost inevitably, Argentina defaulted again, and those bondholders have lost very substantial money.

00:10:13 Dr Oliver Hartwich

Were these bondholders forced into holding Argentinian bonds by regulation that they had to hold some government bonds?

00:10:20 Graeme Wheeler

No no, no, not at all.

00:10:22 Dr Oliver Hartwich

No. So they were just optimistic?

00:10:24 Graeme Wheeler

Yeah, a lot of them were just impressed with the yield, the 8%. But one of the things that is a corollary of the quantitative easing that central banks have done is you've basically seed yield compression across a whole range of asset classes, and you know, a miss pricing of risk.

00:10:44 Dr Oliver Hartwich

You raise a very interesting point here with Argentina, so you pointed out to Argentina's history and nine defaults over I don't know how many years, and yet, when it comes to issuing a new bond, the markets are jumping at it. Would you say that this is perhaps an indication of an ignorance of history? If you like that, we are perhaps too steeped in our mathematical models and our macro models, and we've completely forgotten the political reality, the historical reality, the cultural reality. That would actually be perhaps even more important to know than just putting some data through a macroeconomic model.

00:11:20 Graeme Wheeler

I think there's an element of that. I mean, a lot of investors have similar benchmarks. They have similar risk models and they want to get the profits of those that have preceded them. So, in essence, by investing, they in fact drive the yield lower of those securities, and it might be a very risky asset with great credit risk. So instead of basically seeking a higher risk premia for that investment, their actions in fact compressed the yields. So yeah, I think that people have pretty short memories sometimes about credit exposure and past records.

00:11:57 Dr Oliver Hartwich

Bryce, you've also had the benefit of being around for a long time, so you've seen all of these cycles, and each time there's someone saying but this time is different. Has it ever been different?

00:12:07 Bryce Wilkinson

Oh no, that will never change. Yes, how the future will unfold as is not predetermined. So there will always be differences of views about it. The thought I have on this question you're raising of markets, not getting things right, I feel that the bond market, the global bond market, isn't really a market as sort of someone like HIEC would see it. We've got heavy involvement from governments getting their own banking systems to buy their bonds. There are these big sovereign bonds. Fund managers are wealth managers around the world and you know their objectives aren't pure, their objectives are political, strategic, some of them in parts. So, a question Graeme might be able to throw some light on is the one he raised on Argentina. Just who were buying the bonds in 10s of billions of dollars worth at these sort of negative yields, in the case of some of the government bonds. And you know, to what degree is it these big sovereign funds which affect market pricing?

00:13:17 Graeme Wheeler

Well, in the case of Argentina, a number of commercial banks were buying those bonds. A number of hedge funds, a number of European investors, definitely. I mean it's, you go back to probably around I think 2015 or so. You had 18 trillion U.S. dollars equivalent of negative yielding bonds in the markets and a lot of those were five-year and 10-year maturity, so the longer duration bonds so there's a lot of interest rate risk around them, and the only way basically an investor would make a profit is if the yields fell.

00:14:00 Dr Oliver Hartwich

But do you think that level of negative trading bonds would have been possible without regulatory or political intervention?

00:14:07 Graeme Wheeler

What do you think Bryce? That's a, that's an interesting question.

00:14:11 Bryce Wilkinson

It's very hard to believe isn't it, that. The markets, as Graeme said, just stopped pricing risk. A risk differential just fell away to almost anything. There must be enormous sort of blot on people's balance sheets at the moment. Did you say 8 trillion bonds at - 18 trillion bonds at those yields, the capital losses on that already.

00:14:33 Graeme Wheeler

Oh, just phenomenal.

00:14:34 Bryce Wilkinson

Just phenomenal. There's going to be a lot of grief.

00:14:39 Dr Oliver Hartwich

Since we are already talking in historical dimensions when you're looking at the world today, the world of monetary policy in 2022, what does it remind you of? Are there any periods in our recent history or longer history that you think are comparable to the current situation we're experiencing? Is that something that reminds you of the 1920s leading to the Great Depression? Is that something that reminds you may be off the GFC, or is it something completely different?

00:15:05 Graeme Wheeler

it's a mixture of different episodes, I think. I mean, you've got a serious inflation problem. You've got the developing world, especially highly exposed to debt and the World Bank recently basically said that there's probably up to 100 countries developing countries that need to reschedule their debt.

00:15:28 Dr Oliver Hartwich

And a lot of them are indebted to China these days.

00:15:31 Graeme Wheeler

Quite a lot of them yes, but also to commercial banks. And I mean those that are mostly exposed are those that have U.S. dollar debt. Because the US dollar is appreciating quite strongly and US interest rates are certainly going to rise further.

I mean, we could easily see the Fed funds rate above 3 ½ per cent by the end of the year.

00:15:51 Dr Oliver Hartwich

Isn't that interesting? I mean in 2007-8-9 at the time of the GFC, the big talk was we need to deliver it because we realized we had too much debt in the global economy and we need to get out of this somehow. Now, a bit more than a decade on, actually there is no delivering at all, quite the opposite happened, so why have we not learned the lesson, back then, around 2008?

00:16:15 Graeme Wheeler

It's a good, it's a very good question. I mean part of the rise in debt is due to COVID and respective public debt. I mean you saw debt to GDP ratios in many advanced economies increased by 20 percentage points over that two year period. But a lot of it is just a climate of very low interest rates and where governments are doing massive quantitative easing and injecting huge amounts of liquidity into the economy. I mean, you'll get a situation where zombie firms will survive very easily where all sorts of people can get access to credit and will drive up asset prices.

00:16:56 Dr Oliver Hartwich

On your public debt point, I read recently that it took the United States more than 200 years to have seven trillion U.S. dollars in public debt. And that was exactly how much they added in the last couple of years. So, this public debt thing is one thing, but there's a lot of private debt as well. There's a lot of private debt linked to probably overvalued housing markets, mortgage debt. And again, back to the question, we had all of these problems around 2008. It was pretty visible. We had the collapse of the US housing market, Fannie Mae and Freddie Mac at the time. Why did we not actually learn these lessons? Would it have required maybe an international equivalent of a royal Commission after the GFC to figure out what went wrong to prevent that, why did we never get this?

00:17:43 Graeme Wheeler

It's a puzzle, isn't it? And I think part of it is in a number of advanced economies if you look at middle income salary levels, they haven't increased in real terms very substantially in recent decades. Now part of that is due to the globalization, but I think a number of governments around the world are very keen to see greater levels of home ownership. And encourage homeownership as a form of savings as a form of increasing wealth. And so, if you look at bank balance sheets, it's a huge part of their lending. Now I was, when I was in the World Bank, I was responsible for leading all the discussions with the IMF around the time of the global financial crisis. And I remember the US housing market. The US had fifty million mortgage holders and at the peak of the global financial crisis, 24% of households that had mortgages had negative equity and another 5% of households had equity of less than 5%.

00:18:53 Dr Oliver Hartwich

And a few of them went on recourse loan, so they could just walk away from them.

00:18:56 Graeme Wheeler

Oh, absolutely. And so, you know, I think there's a very strong incentive for banks to provide mortgage lending. A lot of them see it as low risk in terms of risk weighted assets. They see less credit exposure with it than some of the more risky commercial lending. And governments are very keen to see high levels of home ownership in economies.

00:19:23 Dr Oliver Hartwich

So, we've got banks. We have central banks, regulators, politicians. Where do you see the main culprit for what's happened in global finance over the last 10-15 years, Bryce?

00:19:35 Bryce Wilkinson

I think that it's that governments have got big and got unrestrained. So, the global financial crisis was big. Big problems in the housing market, largely government driven, with the failure of Fannie May and Freddie Mac. That created a world banking crisis which governments bailed out and so it's become the public debt crisis. The sort of problem we've got now. And governments are behaving as if money is not a constraint, and the Ukraine war comes on and it's a few more billions sort of put on the tag. Governments are sort of spending like a household would if it could just keep piling it up on the credit card and never had to deal with a debt problem. And it's that, so we got the situation at the moment, you know, and you see them when you look at it, that firm after firm is struggling to hire labor. Meanwhile, government sort of paying great wage rates and pumping up state employment, so it's the state which is expanding, while the people who generate the incomes and the wealth which states depend on to get the tax money is rolling in it. So I think it I think at the end of the day, governments have lost their way. They've become too big and money is too easy and their control the central banks as part of that problem.

00:20:57 Dr Oliver Hartwich

Which leads us straight to your joint paper. So, I've already mentioned the title of the paper *How Central bank mistakes after 2019 lead to inflation*. That reminds me of Milton Friedman's famous quote that inflation is always and everywhere a monetary phenomenon. So, would the summary of your paper be that central banks actually just created too much money and inflated the monetary base too much, and that's what caused the current inflation problem?

00:21:26 Graeme Wheeler

Yes, I think that central banks have made some serious errors of judgment in conducting monetary policy over the last two years. We've got inflation at a 40-year high, and if you look at the US over the last two years, you've had inflation of 14 percent, 12% in the in the UK. Now some central banks suggested that this was due to damaged supply lines due to COVID restrictions for example. The shortage of microprocessors from Taiwan, for example, or it was due to Russia's invasion of Ukraine and the impact on energy prices, wheat and fertilizer. And now factors that have affected inflation, but they are not in any way the main drivers of inflation.

00:22:15 Dr Oliver Hartwich

Because when that happens, what you usually get is you have a shift in relative prices in the economy. So, something goes up and another thing will go down.

00:22:23 Graeme Wheeler

That's exactly right. I mean you've got several countries that now have annual inflation that's relatively low compared to the rest. I mean, in a 2 to 4% range you see countries like China, Japan, Switzerland. There's several Asian economies, and if you look at core inflation, which is headline inflation less food and energy then over the last two years, core inflation has accounted for 70% of headline inflation, and the US and UK. And 60% of headline inflation in France and 50% in Germany. So the main reason why we've had the surge in inflation is this extraordinary monetary and fiscal stimulus that has been applied following the spread of COVID. But now I can understand the fiscal stimulus in terms of assistance to businesses and households and trying to sustain income levels. But what I can't understand is this extraordinary monetary stimulus which pushed up commodity prices, equity markets, house prices. And spilled over into product inflation that we're seeing now. I mean, quite frankly, central banks over did the scale of QE. Many continued at massive programs, even after bond yields rose in late 2020, and the evidence was clear that the economies were stronger than forecast and inflation pressures were starting to build. So central banks have seriously damaged their credibility and that's something that they need to address honestly and address with the public.

00:24:09 Dr Oliver Hartwich

I'm not going to ask you the next question Graeme because I would want to spare you the need to comment on your successor at the Reserve Bank, so I'm going to ask the same question, but to Bryce. Just to bring it a bit closer to home, where you say that central banks have increased the monetary base too much. Let's exemplify this with the example of the RBNZ. We had John McDermott actually, in this podcast only just a few weeks ago and he pointed out two things. First of all, in February 2020 the monetary base was just under 15 billion dollars. As of today, it is around $54 billion. We've had a massive increase in the monetary base, and John predicted that this will now filter through the price level unless we wind it back and he had a second example of Norway. So, John McDermott also pointed out that while all central banks of course increased monetary stimulus at the beginning of COVID, the Norwegians were much faster at winding it back. So, they are basically now at the kind of monetary base level they had before COVID, whereas we are now more than threefold above that. Does that explain our inflation problem?

00:25:15 Bryce Wilkinson

Oh yes, it does. It's the bigger expansion of their money base and very importantly to the very low interest rate which would have stimulated the housing market and would have been part now of raising inflation expectations. And the central government, governor of the bank, encouraging banks to get out and keep lending. Which was a bit bizarre because he was always had been saying earlier that they needed higher reserve asset ratios, because their balance sheets were already better than prudent, so that was a mixed signal. But the scale of it just one figure to show the scale of the problem, the Reserve Bank with great transparency has got a paper loss of $8 billion on the bonds it was paying too much, far too much to buy, building prices up, and yields down. And that 8 billion loss, that's about $4000 per household for New Zealand. Well, that's a massive sort of hidden tax on householders. It's an opportunity loss, but that's what you get when you pay too much for assets and it's not your money. It's just too easy. And too hard to be held properly accountable for.

00:26:35 Dr Oliver Hartwich

Let's get back to the core of your paper. You have a list of six things that central banks around the world got wrong. You can read this as a definition of all the failures, but you could also read it in reverse. You could say OK, if these were the mistakes, these are all recommendations, now how to fix things. And I want to take you through the list and just get a few comments from you on each of the six points. Your first point, and we already touched on that a bit earlier, central banks became overconfident in their inflation targeting frameworks. What do you mean by that?

00:27:07 Graeme Wheeler

Well, I think they became very confident that they could maintain low inflation for a long period of time and that they could have what they saw as the best of all worlds in a way. If they were going to provide this enormous stimulus that they could have very low interest rates, in fact some central banks had negative interest rates. And they could have these absolutely massive amounts of quantitative easing by injecting all, you know, huge amounts of liquidity into the economy, and that inflation would remain low.

00:27:41 Dr Oliver Hartwich

So, if central banks should not use these frameworks, what other alternative frameworks should they use?

00:27:50 Graeme Wheeler

Well, I think flexible inflation targeting still has an important role. I mean price stability is a valuable thing in the sense that if you can create a situation where businesses and households in doing the undertaking their business and carrying out their lives and don't have to worry about inflation, then that's a good thing. But they lost sight of their ability to maintain low inflation under all sorts of circumstances. And I think they lost sight of the importance that these global supply side factors have played in keeping inflation low for a long period of time. And some of those just don't, just reversed.

00:28:34 Dr Oliver Hartwich

The second point on your list, central banks were overconfident in the models they used to base monetary policy decisions. So, a general distrust in economic modeling and macroeconomic modeling, or just a distrust in specific kind of economic modeling, Bryce?

00:28:51 Bryce Wilkinson

Well, it's a general distrust, I think. Yeah models are an oversimplification of the situation, they have to be. And they represent the modelers' perspective on how things work, but those are tentative and the transmission mechanisms for monetary policy are variable in circumstance dependent… depend a lot on expectations. People can read what other central banks are saying and say, oh well I think they're going to do the opposite. Or yes, they're really determined to do that. Those are things which can't be mechanistically dealt with in a model.

00:29:28 Dr Oliver Hartwich

OK, which leads us to point #3 and that's one for you Graeme. Central banks were excessively optimistic that they could successfully fine tune economic activity. So, is that a distrust in economic planning more widely than central banks? Or what do you mean by that?

00:29:45 Graeme Wheeler

Well, monetary policy is always, and it's well known to be a blunt instrument of economic management. And it's always difficult to know exactly what growth path an economy is on. I mean partly because you get a number of revisions to statistics about GDP and the lags on those can be quite long in terms of the corrections coming out, but you're also never clear what the transmission path of monetary policy will be. It could be through wealth effects. It could be through the pricing of risk assets. It could be through interest sensitive expenditures. It could be through the exchange rate. And you're never sure about the lags involved, how long it will take before you start affecting economic activity. So I think the central banks just got too confident, far too confident about their ability to fine tune the economy.

00:30:43 Dr Oliver Hartwich

That is almost a Hayekian argument, so you say that no one can really centralize the necessary knowledge to actually make these decisions and plan an economy.

00:30:53 Graeme Wheeler

No, that’s absolutely right. And you know, as Bryce was just talking about the models. I mean, the models are highly simplified. They’re based on what we call output gaps and some of the key ingredients in those models can’t be observed. So, you’re looking at, you know what’s the path of potential output? What is the output gap at any point in time? What is the neutral interest rate which is neither stimulatory nor contractionary? And how does the actual rate compare to that. and they’ve got very simple assumptions about mean reversion. They’ve got simple assumptions about wage determination, flat Phillips curves for example. So, they just got over confident in their ability to fine tune an economy, and but I’d also question the judgment in that for the economy as a whole, you have a very steep supply curve because of COVID and you’ve got very very large fiscal stimulus. So why are the central banks injecting so much liquidity into the economy? To me it was just bound to come out not only in house price inflation, but also product inflation.

00:32:09 Dr Oliver Hartwich

So, if you have a central bank that is too confident in its own modeling, if it is also willing to try to fine tune the economy, that leads us almost straight to point #4 on your list, and that is central banks took their eye off their core responsibilities and focus on issues that were much less central to their rules, Bryce.

00:32:29 Bryce Wilkinson

Yes, and the particular indicator of that is the major central banks got, well nearly most of the central banks in the world, getting together and getting focused on climate change and they had to sort of try and make a case that climate change, which is a slow gestation sort of distant thing is, a real threat to global financial stability.

That case, they still haven’t really been able to make, but they are putting a lot of resources into trying to make it, and no doubt they’ll produce some papers which do make the argument, but I don’t know how many people it’s going to convince, but that’s a massive distraction given the chaos which was looming up on them of unprecedented increases in global liquidity, unprecedentedly low interest rates from the central banks and unbelievable growth and public debt ratios, which totally violated the normally prudent rules they set out, for example in the in the European Maastricht Treaty. So yeah, big distractions.

00:33:40 Dr Oliver Hartwich

And these distractions lead us straight to the next point. Point #5 on your list. Dual mandates for monetary policy create conflicts. So dual mandates of course meaning that central banks be in charge of not just price stability but also supporting employment. Actually, we might soon see a triple mandate in the case of the Federal Reserve. The Biden administration is now thinking about giving the Federal Reserve a third mandate for racial equality. That is not the way a Central Bank should go, looking at you Graeme.

00:34:12 Graeme Wheeler

Well, central banks in recent years as Bryce said, have taken on a lot more responsibility. I mean, they've moved into the area of climate change, some of them into the areas of income and wealth disparities. Sometimes social considerations.

00:34:28 Dr Oliver Hartwich

Housing?

00:34:34 Graeme Wheeler

And yeah exactly. And you mentioned the US. I'd be surprised if that ends up in legislation given some of the concerns in the Republican Party around that.

00:34:40 Dr Oliver Hartwich

It would also be difficult to imagine in practical terms how a central bank would achieve that target.

00:34:45 Graeme Wheeler

Oh absolutely. They don't have the instruments or the expertise.

00:34:49 Dr Oliver Hartwich

Just as you wouldn't put at central bank in charge of running the education system.

00:34:52 Graeme Wheeler

That's absolutely right, and they don't have the expertise on climate change issues and they don't have the policy tools. But where the dual mandate becomes problematic, especially, is when central banks are charged with not only price stability, but also maximizing employment growth. And every central banker in the world, at least those that I've worked with, has always looked at the labour market when they're looking at policy decisions, because wage inflation and employment considerations and productivity and growth are all part of the rubric that you want to be studying. But where problems arise is when you don't give primacy to price stability. Because you can get a situation which is really where we are now in many cases and it will become increasingly clear, you have very high inflation, and you have employment that may be growing slowly or maybe falling and unemployment rising. So, if you have a dual mandate and no primacy to either of those objectives, then what are you supposed to do in the Central bank? Are you supposed to raise interest rates in order to contain inflation pressures that will inevitably create more business failures and higher unemployment? Or are you supposed to lower interest rates? So, it's, if you are going to have other considerations to price stability, I believe it's critical that you give primacy to one of those objectives and the appropriate one is price stability.

00:36:30 Dr Oliver Hartwich

Well, in theoretical economics question whether central banks should target price stability or employment, or whether they can choose between the two, that had been solved since the 1970s. I remember, and you probably do too, German Chancellor Helmut Schmidt at the time with the famous saying, it was in the mid-70s, if he could choose between 5% inflation and 5% unemployment, he would take the 5% inflation, while then a year later he had both.

00:36:57 Graeme Wheeler

Yes, he did.

00:36:58 Dr Oliver Hartwich

So that was a misunderstanding of economics at the time, and I think from roughly the late 1970s, the profession had broadly agreed on the fact that actually it is price stability that central banks should focus on. Yes, you might have in a very short run some choice between the two between unemployment and inflation, but in the long run what a central bank can do is price stability and basically that had been settled. So how surprising is it for both of you that nearly 40 years on we have politicians now pretending as if that debate never happened?

00:37:29 Bryce Wilkinson

As I said before, I think that governments have lost track of what they can achieve and what they cannot achieve. They've overextended public expectations of what governments can achieve are much too high, and prudence has been a casualty of that. But that's now ingrained in the way of things. But so the paper is calling for a lot deal of, a great deal of self-examination over what happened in the last decade and more. And I think central banks need to do that. But so do governments. But the prospects of how that's going to happen are not clear, but hopefully this paper is a contribution to the understanding of the need for those things.

00:38:19 Dr Oliver Hartwich

And that leads us to point #6 on your list and that's actually a question. The question is, did some central banks try too hard to support government political objectives in making judgments about monetary policy? Question mark. Graeme, which governments, which central banks did you have in mind?

00:38:38 Graeme Wheeler

Well, I'd rather steer clear of that if I could.

00:38:42 Dr Oliver Hartwich

Yes, go ahead.

00:38:43 Graeme Wheeler

There's a, it's a complicated relationship in the sense that central banks are aware that governments can withdraw at any point in time the mandate that they've given them in terms of operational independence over monetary policy. But equally, you find that central banks are reluctant to publicly criticise government policy and particularly fiscal policy or regulatory issues around the housing market. For example, that's true in many countries. You've also got a situation where the central banks depend upon the government for funding their operating expenditures, either through direct transfers or through being able to retain some of the seigniorage, for example. So, it’s a complicated relationship and I would question whether some central banks have basically tried to please their governments far too much.

00:39:43 Dr Oliver Hartwich

Sometimes the relationship runs the other way round. I mean for a while it looked as if the ECB was the only functional institution left in Europe because the European Commission couldn’t do anything, the national government couldn’t agree on anything. And then they all relied on the ECB to bail them out of the Euro crisis.

00:39:58 Graeme Wheeler

Yes, and I think that’s right. And I think the central banks started to believe that they really were the only game in town that somehow that they were the first port of action if you like for addressing economic policy. That they superseded the Treasury in that role, a number of them became asset managers in many respects in terms of the quantitative easing, in which sort of bonds might they buy. And you saw that in the ECB for example, where you suddenly start buying different countries bonds in order to narrow the spread.

00:40:35 Dr Oliver Hartwich

Well, let’s talk a little bit about the ECB if we may. I mean, I’ve written so many columns about European monetary policy, and I’m not a great fan of the ECB. But to be fair they are put into an impossible position because monetary union was badly designed. I think that’s probably fair to say it started with members that were not ready for it and the rules were never followed, and by the way they were not even followed for Germany when they had excessive budget deficits in the early 2000s. And now the ECB is in an impossible position. There is no fiscal equalization happening in Europe. And they don’t want to be blamed for this political Euro project, should it implode? So, does the ECB even have a chance to fulfill its mandate?

00:41:22 Graeme Wheeler

Well, it’s enormously challenging for them, particularly because as you say, there’s no fiscal equalization mechanism. And you’ve seen in the past that some of the debt rules that they’ve had, the 60% public debt ratios, for example, and what sort of flow conditions around budget deficits to GDP they’ve readily been broken. And you’re there with countries with different needs and different requirements. So, for example, you see inflation quite high in Germany for example with the Bundesbank would like to have seen monetary policy tighten much more quickly and have reduced QE, much less stimulus and some of the other countries as well.

00:42:07 Dr Oliver Hartwich

The Baltic states.

00:42:18 Graeme Wheeler

So you get into a very tricky situation where the ECB has so many diverse countries with different needs. And they have different productivity records. I mean German productivity is way higher than France and

Italy, let alone the southern European countries. So, the ECB board meetings can sometimes be fractious as you know.

00:42:33 Dr Oliver Hartwich

I imagine.

00:42:34 Graeme Wheeler

As they try and work out what to do but they are in this situation where they are buying sovereign bonds of different members and they're really asset managers and they're taking on fiscal responsibilities and trying to in many cases trying to create confidence in in the Euro.

00:42:54 Dr Oliver Hartwich

Just a follow-up question on that and I'm usually irritated when people say that the solution to the Euro's problems is fiscal equalization, because to me that sounds as if it's just glossing over the main problem, which you just mentioned, which is the productivity for differential across Europe. So, wouldn't that just mean actually glossing over the fundamental construction flaws of the eurozone? I mean yes, you can keep it alive, and I think you can keep the euro life for as long as there's political will, because for economic reasons it wouldn't have come into existence. So, would fiscal equalization be the solution to Europe or just a band-aid.

00:43:34 Graeme Wheeler

I'm not sure it'd be a solution, but it would help I think in terms of the degrees of freedom facing policymakers and governments. They're getting, fiscal equalization is going to be immensely challenging given the sovereign issues.

00:43:50 Dr Oliver Hartwich

But the fiscal equalization Bryce would probably only make the cost of money to Union more obvious to voters in central European countries.

00:43:59 Bryce Wilkinson

Oh yes, absolutely.

00:44:00 Graeme Wheeler

Yes, we agree.

00:44:02 Bryce Wilkinson

Yes, and in particular the southern Europe would be looking at German voters to subsidize them indefinitely. And the awful thing there is well when would it stop? Because once you get used to a particular level of subsidy, well then you need more. So what would be the limit on it. Well the limit can only be political and there can only be very fractious and divisive for Europe. We all understand that you know the European project was one to try and avoid another European war, which is a goal we could always subscribe to if it was going to be successful, but the trouble was the structure which they built up in the early 1990s, wasn't one which is going to be sustainable. And Martin Feldstein, sort of top public finance economist at Harvard University, and later, a chairman of the Council of Economic Advisers, published a very prescient paper in the early 1990s in the Journal of Economic Perspectives. And he said, what we economists have to understand is that this Euro structure doesn't make sense in economic terms. It doesn't look sustainable. It's not an optimal currency area, which was a well-developed concept in economics, but it's done for political reasons.

And the optimists at the time amongst the economists and there were some of them said we agree with your analysis but when it starts to fall apart, the governments will come together and do the right thing to make it sustainable, and that's been the debate ever since.

00:45:38 Dr Oliver Hartwich

Indeed, I remember actually reading an interview with Milton Friedman in the early 2000s, where he said the euro wouldn't survive the first major recession. I think Milton Friedman probably underestimated the political will to keep this project alive at all costs.

Now that we have analyzed the last 20 or 30 years of monetary policy together, I mean it's easy to spot some mistakes in hindsight, of course, but I want to ask you specifically, Graeme. Do you have any regrets, in hindsight? Things you would have done differently when you were in charge?

00:46:10 Graeme Wheeler

Ah, there's always things that you go home and puzzle about and say have we made policy mistakes here? I think looking, and I'm conscious that you know if you live in a glass house you shouldn't throw stones, but I'm very keen to collaborate with Bryce on this paper because the mistakes that have been made by central banks are so grievous, they're so damaging in terms of the adjustments that lie ahead, and also to the damage to their own credibility and the confidence that people have in them in terms of price stability, as a bastion of price stability. I was fortunate in that during my time, as I say, we had growth that averaged 3% and employment growth average 3%, there was no productivity growth which isn't the central banks issue, but inflation was below the midpoint of 2% where we would like it to have been over on average. Mainly due to those globalization factors.

But we did have a situation that I that I do regret. We did get wrong. Though at the time it was when we made that judgment, it certainly wasn't clear that we were doing anything wrong. We were in a situation where the New Zealand economy was growing more rapidly than the rest of the world, or at least the advanced economies in the world. So, we're a bit out of cycle and we started to see inflation pressures coming through in the what we call the non-tradeable sector. Now that's non tradeables are things that are not traded over a border so it tends to be government, local government services to some extent and the building industry. And we started to see inflation of the order of 3 1/2% in a non tradeable sector. Now the non tradeables accounted for about half of the CPI and we started to see inflation expectations increase so we raised interest rates three times by 25 basis points, so 3/4 of a percent in total. And we had to unwind that and that put pressure raising interest rates put pressure on exporters and it had it carried some costs. There's no question.  But what we underestimated was just how low or how negative inflation was coming from the rest of the world in terms of globalization factors. So I have a regret about that.

What I don’t regret was that we felt on the evidence at the time that we were doing the right thing. And acting quickly to try and stop inflation pressures become widespread and do great damage to the society. I don’t regret our intentions at that point in time given the information we had.

00:48:56 Dr Oliver Hartwich

Just to follow up on that, you mentioned that central banks around the world have made severe mistakes in the last decades. Now Central Bank policy doesn’t fall from heaven. It is made by people and especially in central banking and monetary policy people often play very dominant roles. We all probably remember Paul Volcker, the legendary chair of the US Fed. Remember Alan Greenspan. Remember, maybe Karl Otto Pöhl at the Bundesbank. So, it’s always personalities making these decisions. Now you say there were severe mistakes made. I don’t want you to name anyone here, I’m just asking, how difficult is it for the global central banking community to have an open discussion about these mistakes, given that they are so closely linked to personalities. People who you’ve worked with for decades, you’re probably friends with, whom you’re in touch, who you respect, who you like. How difficult is it then to have an open debate about the mistakes being made when all of these mistakes, or many of them, are so personally linked to some personalities who are working in the system?

00:50:01 Graeme Wheeler

Yes, I had the... It’s a very good question and I had the great pleasure to meet all three individuals, one-on-one once.

00:50:09 Dr Oliver Hartwich

You have to tell me more about Karl Otto Pöhl. He was such a figure.

00:50:12 Graeme Wheeler

He certainly was, we had lunch one day. I was very fortunate.

00:50:17 Dr Oliver Hartwich

And he resigned of course, in protest against Helmut Kohl at the time.

00:50:20 Graeme Wheeler

Yes, yes. I was in a… It’s interesting, you know. I was in a meeting with Alan Greenspan and Jim Wolfenson at the World Bank and Alan Greenspan and Jim Wolfensohn were very close friends. They used to play tennis together and meet each other regularly. And both were coming up to a point of retirement. So, Jim invited Alan Greenspan and there were about six of us around the table and someone inevitably asked the question, well, what do you see as the greatest threat to the global economy? And this was about this was about 2006 or so 2005, 2006. And he, what keeps you awake at night in essence? And he leans back in this chair and we all sort of waited to hear the answer. And he said, well, I think it’s the credit risk in the Chinese banking system. And little did he realise or others realizing ourselves included, that the greatest risk was in front of our eyes in terms of the US Banking and housing markets and things like that. Central bankers do talk very frankly with each other one-on-one, and they do when they have discussions in Basel, every two months. There’s a group of probably about 40 central bankers that do that, and those discussions with New Zealand included are valuable. What I think they need to do now is to really study the things that that they’ve got wrong and review the sorts of issues that Bryce and I raise in the paper and other people who have raised them as well in the media. And indicate what they've learned from that process and what steps they're taking to rebuild public confidence, because that's absolutely critical.

00:52:12 Dr Oliver Hartwich

Now looking at the outlook for inflation and for the economy more generally Bryce. Where do you see this current inflation crisis going? And actually, what would you like to achieve with your joint paper?

00:52:26 Bryce Wilkinson

Well achievement with the joint paper is seeing a rational and deliberate, purposeful public debate. Something saying yes, there are issues here. We don't want a repeat of what's happened, what changes to institutional arrangement should be considered and debated. On your, the first part of your question about the outlook. The reading from experience and the economic literature on this is quite big. Is that wind countries, governments get into these big public debt problems and inflation problems it's a long, slow road, slog out out of it. So a period of weak economic growth and economic growth, a lot of pain, bankruptcies from inflation, people losing money. And rather desperate attempts by governments who force people to do things that they don't want to do, and in particular to buy government paper at prices which they wouldn't want to pay given the inflation outlook. So yeah, the countries have been in this place in the past many times. And the message is that it's tough to get out of it.

00:53:41 Dr Oliver Hartwich

Same question for you Graeme. Where do you see the current situation going and what would you like to achieve?

00:53:48 Graeme Wheeler

I certainly agree with Bryce's comments. We're going to see below trend rates of growth, certainly in the advanced economies over the next two years. I think there's a significant probability that the US may go into recession in 2023. The UK I think is an immensely difficult situation. I think we're in a very difficult situation in New Zealand as well. I think some of the most difficult problems will appear in the developing countries as we've talked about before.

00:54:24 Dr Oliver Hartwich

Sri Lanka as a starting point.

00:54:25 Graeme Wheeler

Well, that's just the starter, but there are many potentials. Sri Lanka is out there, particularly those that have corporate sectors and governments that are highly exposed to the USA dollar, they're experiencing real pain.

00:54:39 Dr Oliver Hartwich

South America

00:54:40 Graeme Wheeler

Yeah, as well as high inflation and food and energy prices, and so a number of those countries will need debt restructuring. You'll see poverty levels increase significantly. Because in the end, the adjustment of monetary policy most acutely falls upon the least disadvantaged and the most vulnerable people in society. What would I like to see from the paper? I'd really like to see, as Bryce has said, a public discussion on these sorts of issues, and I would like to see central banks reflect very deeply on these sorts of issues that we've raised in the paper and then to comment publicly, explain to the public, what steps they're taking to rebuild the confidence that the public should have in them.

00:55:27 Dr Oliver Hartwich

And let's hope that that is exactly what your paper will achieve. Broader discussion, a deeper discussion, a wider discussion and how to move forward on how to get out of the current inflationary mess. But for now, thank you, Graeme. Thank you, Bryce. It was a pleasure to talk to you and we hope that your paper gets a lot of attention.

00:55:45 Graeme Wheeler

Thank you, Oliver.

00:55:47 Bryce Wilkinson

Thank you, Oliver.