

# Taking the textbook approach

The economist and Governor of the Bank of Israel sees a role for both fiscal and monetary stimulus, saying Israel avoided recession by monetary policy alone, writes Geoff Winestock.

**S**tanley Fischer wrote the book on economics. His textbook *Macroeconomics*, educated the past generation of economists. He supervised the PhD thesis of Fed governor Ben Bernanke at MIT.

So you would think Fischer would be a little ashamed of his profession in the wake of the global financial crisis. Has he fundamentally questioned any of his ideas given the total failure to pick the coming crisis by so many eminent economists, including his former student Bernanke? Is he planning to rewrite the book?

No. "I don't find myself having an existential crisis," he says. "I think this is actually a victory for the textbooks."

Fischer was in Australia last week along with other top central bankers in his current role as governor of the Bank of Israel to take part in a Reserve Bank of Australia symposium on the last 50 years of monetary policy.

His intellectual authority comes not just from his academic career but also from his hands-on role as first deputy managing director of the International Monetary Fund from 1994 to 2001 during the Asian financial crisis.

He has not always been popular in Australia. In his time at the IMF during the Asian crisis he sparred with then treasurer Peter Costello. Fischer then served as vice-chairman of Citibank but took his current job at the Bank of Israel for sentimental reasons, which hardly puts him at the centre of the world economy.

But as one of the high priests of the central banking profession, the 66-year-old's views count. Speaking to *The Australian Financial Review* after the event, he explained what he drew from the conference last week.

In a nutshell, Fischer says the crisis was due to bad banking regulation and banks will have to accept much tougher regulation. If they complain, tough.

He agrees with RBA governor Glenn Stevens that central banks have to start targeting asset prices, not just inflation, which could mean house prices will have to grow more slowly.

He is in favour of fiscal stimulus as an antidote to recession but he points out that Israel managed to avoid a recession by monetary policy alone.

Fischer warns that, though during the crisis the IMF was successful in bailing out some countries on the brink of default, that only works if it can be sure a country is not too corrupt.

And he is not all that hopeful that there is any easy solution to the problems of regulating large, complicated banks.

The key political background for the conference was the backlash from banks in Australia, and especially in the US against what is perceived to be a tide of excessive regulation in the wake of the global financial crisis.

Commonwealth Bank of Australia chief executive Ralph Norris last week complained that he was being hit by harsher rules on capital and liquidity even though his bank had performed well during the crisis.

It is an argument that leaves Fischer cold. "There are people who say if we regulate the system more, there will be less credit given. We will be doing damage to the ability to lend money. That's all fine but since the banks were handing out too much money before the crisis, the fact that the rate of credit growth may be slower than it was in 2007 I don't think that would be a problem, I think that's something we want," he said.

To those who say regulation will hurt innovation he says the innovation might easily be the equivalent of the

incomprehensible sub-prime mortgage products marketed by people with maths PhDs that caused the global crisis.

As bank supervisor in Israel, Fischer avoided an Iceland-style meltdown in the banking system. On the other hand, he admits it was not that hard to regulate a system with only seven banks, and only two really significant ones.

Cracking down on banks was pretty much received wisdom at the RBA gathering which included lots of angry banking regulators. Even Andrew Crockett, president of JPMorgan International, conceded in a speech that "light touch regulation" had failed.

But Fischer goes further than most. For instance, he endorses moves to try to stop the international investment banks engaging in traditional savings and loan banking. That idea is being promoted by the Obama

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administration and former Federal Reserve chairman Paul Volcker.

Fischer reckons the key problem is that no one knows how to close down any of these complex multinational investment banks when they get into trouble as occurred with Lehman Brothers and AIG. So they need to be kept in line. There are lots of proposals but until the problem of "resolution" is solved, the big investment banks need special treatment.

"Anything can go too far. I don't think the Volcker plan goes too far," he says. "I think they are basically right."

The other dollop of blame that Fischer hands out goes to the US Federal Reserve's monetary policy; it was reluctant to raise interest rates despite evidence of a dangerous build-up in housing debt and an irrational rise in house prices. The Fed said its only job was to target inflation and that the job of pricking asset bubbles was too risky.

It is a mistake that Australia and Israel avoided. They were among a group of countries that raised rates early in the cycle.

Fischer agrees with the keynote speech at the RBA symposium last week by governor Glenn Stevens who said the episode shows that central banks should target not just inflation but also try to slow the build-up of excessive debt.

"I thought Glenn was right on the mark. The Fed used to pose the issue in terms of: 'Should you try to prick asset bubbles using the interest rate?'"

"That seems to me a kind of an exaggerated way of thinking. The question is: 'Should you try to raise interest rates if you think asset prices are rising too fast?' You don't have to go out and decide that you'd like the bubble to burst right then. You just have to decide that you'd like the asset prices to rise more slowly."

Another big theme in Stevens' speech was the balance between fiscal and monetary policy when it comes to providing a stimulus to an economy in crisis. On the one hand, stereotypical Keynesians argue that in a big panic like the end of 2008, monetary policy doesn't work. Terrified investors keep their money in cash rather than spend, even when interest rates are cut to zero.

Keynes called it a liquidity trap and it is also known as a situation where monetary policy is like "pushing on a string".

Fischer certainly sees a role for both fiscal and monetary stimulus which he says is exactly what the textbooks, not to mention his textbook, ordered. But to those who argue that monetary policy doesn't work, he points out that Israel has provided an interesting counter-example.

Back in early 2009, because of a political crisis, the government lost its majority in the parliament and could not pass a budget, much less any discretionary stimulus spending like the cash handouts in Australia. So all the stimulus came from Fischer's monetary policy: either by slashing interest rates or driving down the currency.

Fischer says Israel is clearly a special case, not least because its banking system was sound. But monetary policy worked pretty well.

The economy grew slightly in 2009, unlike the big contractions in other developed countries, and will grow over 3 per cent this year.

He concedes also that in a crisis, fiscal stimulus policy such as the cash handouts used in Australia works a lot faster than cutting interest rates.

But Fischer says Israel's example is a strand in an argument against those who claim fiscal policy is king in a crisis. "I think the interest rate policy worked; I think you can push on a string if the financial system is still working."

It is an interesting parallel with Australia where interest rates only fell to 3 per cent and could have been cut much further if the government had not stepped in so quickly with its stimulus.

Stevens hinted in his speech last week that he would have cut rates further if the government had not acted. Fischer implies

this might have produced a similar result to fiscal policy, albeit more slowly.

The Greek debt crisis has a deep resonance for Fischer, a veteran of so many stabilisation and bail-out plans at the IMF. He says it is up to the Europeans to work out a system for bailing out the Greeks, if they don't want the

IMF to do the job. He says since the Group of 20 voted to give the IMF extra funds, it has the resources to bail countries out of short-term liquidity crises but he warns that bail-outs must go hand-in-hand with a rigorous program for improving budget discipline.

"If you are dealing with a crisis which is based on the inability of a country to get its budget into shape, if you give them a lot of money it's just going to be wasted again."

In his own patch of Israel, he is now engaged in the unusual role of talking up an economy that usually falls outside the radar of investors largely because of security concerns.

He took an extra day in Sydney last week to address an Australia Israel Chamber of Commerce lunch. As well as promoting Israel's performance he made a careful political intervention.

Some, he says, are arguing that Israel has no need of peace with its Arab neighbours because it has grown by 5 per cent a year for much of the past decade. But Fischer told his audience that a peace deal, especially with the Palestinians, would lead to much faster growth.

The pay-off would come not so much from trade with the Palestinian economy, which is tiny, but from much higher rates of investment by foreign and domestic investors who no longer had to factor in security risk.

"Some people said to me: 'We don't need peace. We grew at 5 per cent without peace.' I think that if we actually had a serious peace deal with our neighbours, particularly the Palestinians, we'd actually do significantly better than that," Fischer says.

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