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Rethinking macro policy

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The global crisis forced economic policymakers to react in ways not anticipated by the pre-crisis consensus on how macroeconomic policy should be conducted. Here the IMF's chief economist and colleagues (i) review the main elements of the pre-crisis consensus, (ii) identify the elements which turned out to be wrong, and (iii) take a tentative first pass at outlining the contours of a new macroeconomic policy framework.

The great moderation (Gali and Gambetti 2009) lulled macroeconomists and policymakers alike in the belief that we knew how to conduct macroeconomic policy. The crisis clearly forces us to question that assessment. In a recent IMF Staff Position Note (Blanchard, Dell'Ariccia and Mauro 2010, which includes a bibliography), we review the main elements of the pre-crisis consensus, we seek to identify what elements were wrong and what tenets of the pre-crisis framework still hold, and we take a tentative first pass at the contours of a new macroeconomic policy framework.

What we thought we knew

To caricature: we thought of monetary policy as having one target, inflation, and one instrument, the policy rate. So long as inflation was stable, the output gap was likely to be small and stable and monetary policy did its job. We thought of fiscal policy as playing a secondary role, with political constraints limiting its usefulness. And we thought of financial regulation as mostly outside the macroeconomic policy framework. Admittedly, these views were more closely held in academia; policymakers were more pragmatic. Nevertheless, the prevailing consensus played an important role in shaping policies and institutions.

One target: Inflation

Stable and low inflation was presented as the primary, if not exclusive, mandate of central banks. This resulted from the reputational need of central bankers to focus on inflation rather than activity and the intellectual support for inflation targeting provided by the New Keynesian model. In the benchmark version of that model, constant inflation is indeed the optimal policy, delivering a zero output gap, which turns out to be the best possible outcome for activity given the imperfections present in the economy. This "divine coincidence" implied that, even if policymakers cared about activity, the best they could do was to maintain stable inflation. There was also consensus that inflation should be very low (most central banks targeted 2% inflation).

One instrument: The policy rate

Monetary policy focused on one instrument, the policy interest rate. Under the prevailing assumptions, one only needed to affect current and future expected short rates, and all other rates and prices would follow. The details of financial intermediation were seen as largely irrelevant. An exception was made for commercial banks, with an emphasis on the "credit channel." Moreover, the possibility of runs justified deposit insurance and the traditional role of central banks as lenders of last resort. The resulting distortions were the main justification for bank regulation and supervision. Little attention was paid, however, to the rest of the financial system from a macro standpoint.

A limited role for fiscal policy

Following its glory days of the Keynesian 1950s and 1960s, and the high inflation of the 1970s, fiscal policy took a backseat in the past two-three decades. The reasons included scepticism about the effects of fiscal policy, itself largely based on Ricardian equivalence arguments; concerns about lags and political influences in the design and implementation of fiscal policy; and the need to stabilize and reduce typically high debt levels. Automatic stabilizers could be left to play when they did not conflict with sustainability.

Financial regulation: Not a macroeconomic policy tool

Financial regulation and supervision focused on individual institutions and markets and largely ignored their macroeconomic implications. Financial regulation targeted the soundness of individual institutions and aimed at correcting market failures stemming from asymmetric information or limited liability. Given the enthusiasm for financial deregulation, the use of prudential regulation for cyclical purposes was considered improper mingling with the functioning of credit markets.

The Great Moderation

The decline in the variability of output and inflation led to greater confidence that a coherent macro framework had been achieved. In addition, the successful responses to the 1987 stock market crash, the LTCM collapse, and the bursting of the tech bubble reinforced the view that monetary policy was also well equipped to deal with asset price busts. Thus, by the mid-2000s, it was not unreasonable to think that better macroeconomic policy could deliver, and had delivered, higher economic stability. Then the crisis came.

What we have learned from the crisis

- Macroeconomic fragilities may arise even when inflation is stable

Core inflation was stable in most advanced economies until the crisis started. Some have argued in retrospect that core inflation was not the right measure of inflation, and that the increase in oil or housing prices should have been taken into account. But no single index will do the trick. Moreover, core inflation may be stable and the output gap may nevertheless vary, leading to a trade-off between the two. Or, as in the case of the pre-crisis 2000s, both inflation and the output gap may be stable, but the behaviour of some asset prices and credit aggregates, or the composition of output, may be undesirable.

- Low inflation limits the scope of monetary policy in deflationary recessions

When the crisis started in earnest in 2008, and aggregate demand collapsed, most central banks quickly decreased their policy rate to close to zero. Had they been able to, they would have decreased the rate further. But the zero nominal interest rate bound prevented them from doing so. Had pre-crisis inflation (and consequently policy rates) been somewhat higher, the scope for reducing real interest rates would have been greater.

- Financial intermediation matters

Markets are segmented, with specialized investors operating in specific markets. Most of the time, they are well linked through arbitrage. However, when some investors withdraw (because of losses in other activities, cuts in access to funds, or internal agency issues) the effect on prices can be very large. When this happens, rates are no longer linked through arbitrage, and the policy rate is no longer a sufficient instrument. Interventions, either through the acceptance of assets as collateral, or through their straight purchase by the central bank, can affect the rates on different classes of assets, for a given policy rate. In this sense, wholesale funding is not fundamentally different from demand deposits, and the demand for liquidity extends far beyond banks.

- Countercyclical fiscal policy is an important tool

The crisis has returned fiscal policy to centre stage for two main reasons. First, monetary policy had reached its limits. Second, from its early stages, the recession was expected to be long lasting, so that it was clear that fiscal stimulus would have ample time to yield a beneficial impact despite implementation lags. The aggressive fiscal response has been warranted given the exceptional circumstances, but it has further exposed some drawbacks of discretionary fiscal policy for more "normal" fluctuations – in particular lags in formulating, enacting, and implementing appropriate fiscal measures. The crisis has also shown the importance of having "fiscal space," as some economies that entered the crisis with high levels of government debt had limited ability to use fiscal policy.

- Regulation is not macroeconomically neutral

Financial regulation contributed to the amplification that transformed the decrease in US housing prices into a major world economic crisis. The limited perimeter of regulation gave incentives for banks to create off-balance-sheet entities to avoid some prudential rules and increase leverage. Regulatory arbitrage allowed some financial institutions to play by different rules from other financial intermediaries. Once the crisis started, rules aimed at guaranteeing the soundness of individual institutions worked against the stability of the system. Mark-to-market rules, coupled with constant regulatory capital ratios, forced financial institutions into fire sales and deleveraging.

Reinterpreting the Great Moderation

If the conceptual framework behind macroeconomic policy was so flawed, why did things look so good for so long? One reason is that policymakers had to deal with shocks for which policy was well adapted. For example, the lesson from the 1970s that, with respect to supply shocks, anchoring of expectations was of the essence was well understood when the price of oil increased again in the 2000s. Success in moderating fluctuations may even have sown the seeds of this crisis. The Great Moderation led too many (including policymakers and regulators) to understate macroeconomic risk, ignore tail risks, and take positions (and relax rules) which were revealed to be much riskier after the fact.

Implications for policy design

The bad news is that the crisis has shown that macroeconomic policy must have many targets; the good news is that it has also reminded us that we have many instruments, from "exotic" monetary policy to fiscal instruments, to regulatory instruments. It will take some time, and substantial research, to decide which instruments to allocate to which targets. It is important to start by stating that the baby should not be thrown out with the bathwater. Most of the elements of the pre-crisis consensus still hold. Among them, the ultimate targets remain output and inflation stability. The natural rate hypothesis holds, at least to a good enough approximation, and policymakers should not assume that there is a long-term trade-off between inflation and unemployment. Stable and low inflation must remain a major goal of monetary policy. Fiscal sustainability is of the essence, not only for the long term, but also in affecting expectations in the short term.

The following are important questions for economists to work on.

Exactly how low should inflation targets be?

The crisis has shown that large adverse shocks do happen. Should policymakers aim for a higher target inflation rate in normal times, in order to increase the room for monetary policy to react to such shocks? Are the net costs of inflation much higher at, say, 4% than at 2%, the current target range? Is it more difficult to anchor expectations at 4% than at 2%? Achieving low inflation through central bank independence has been a historic accomplishment. Thus, answering these questions implies carefully revisiting the benefits and costs of inflation. A related question is whether, when the inflation rate becomes very low, policymakers should err on the side of a more lax monetary policy, so as to minimize the likelihood of deflation, even if this means incurring the risk of higher inflation in the event of an unexpectedly strong pickup in demand. This issue, which was on the mind of the Fed in the early 2000s, is one we must return to.

How should monetary and regulatory policy be combined?

Part of the debate about monetary policy, even before the crisis, was whether the interest rate rule, implicit or explicit, should be extended to deal with asset prices. The crisis has added a number of candidates to the list, from leverage to measures of systemic risk. This seems like the wrong way of approaching the problem. The policy rate is a poor tool to deal with excess leverage, risk taking, or apparent deviations of asset prices from fundamentals. A higher policy rate also implies a larger output gap.

Other instruments are at the policymaker's disposal—call them cyclical regulatory tools. If leverage appears excessive, regulatory capital ratios can be increased; if liquidity appears too low, regulatory liquidity ratios can be introduced and, if needed, increased; to dampen housing prices, loan-to-value ratios can be decreased; to limit stock price increases, margin requirements can be increased. If monetary and regulatory tools are to be combined in this way, it follows that the traditional regulatory and prudential frameworks need to acquire a macroeconomic dimension. This raises the issue of how coordination is achieved between the monetary and the regulatory authorities. The increasing trend toward separation of the two may well have to be reversed. Central banks are an obvious candidate as macroprudential regulators.

Should liquidity be provided more broadly?

The crisis has forced central banks to extend the scope and scale of their traditional role as lenders of last resort. They extended their liquidity support to non-deposit-taking institutions and intervened directly (with purchases) or indirectly (through acceptance of the assets as collateral) in a broad range of asset markets. The argument for extending liquidity provision, even in normal times, seems compelling. If liquidity problems come from the disappearance of deep-pocket private investors from specific markets, or from the coordination problems of small investors as in traditional bank runs, the central authority is in a unique position to intervene.

How can we create more fiscal space in good times?

A key lesson from the crisis is the desirability of fiscal space to run larger fiscal deficits when needed. Going forward, the required degree of fiscal adjustment (after the recovery is securely under way) will be formidable, in light of the need to reduce debt while swimming against the tide of aging-related challenges in pensions and health care. Still, the lesson from the crisis is that target debt levels should be lower than those observed before the crisis. The policy implications for the next decade or two are that, when cyclical conditions permit, major fiscal adjustment is necessary and, should economic growth recover rapidly, it should be used to reduce debt-to-GDP ratios substantially, rather than to finance expenditure increases or tax cuts. The recipe to ensure that economic booms translate into improved fiscal positions is not new, but it acquires greater relevance as a result of the crisis. Medium-term fiscal frameworks, credible commitments to reducing debt-to-GDP ratios, fiscal rules (with escape clauses for recessions), and transparent fiscal data can all help in this regard.

Can we design better automatic fiscal stabilizers?

Discretionary fiscal measures come too late to fight a standard recession. Can we strengthen and improve the automatic stabilizers? A distinction is needed here between truly automatic stabilizers – those that imply a decrease in transfers or increase in tax revenues when incomes rise – and rules that allow some transfers or taxes to vary based on pre-specified triggers tied to the state of the economy. The first type of automatic stabilizer comes from the combination of rigid government expenditures with an elasticity of revenues with respect to output of approximately one, from the existence of social insurance, and from the progressive nature of income taxes. The main ways to increase their macroeconomic effect would be to increase the size of government, make taxes more progressive, or to make social insurance more generous. However, these reforms would be warranted only if they were based on a broader set of equity and efficiency objectives. The second type of automatic stabilizer appears more promising. On the tax side, one can think of temporary tax policies targeted at low-income households, such as a flat, refundable tax rebate, a percentage reduction in a taxpayer's liability, or tax policies affecting firms, such as cyclical investment tax credits. On the expenditure side, one can think of temporary transfers targeted at low-income or liquidity-constrained households. These taxes or transfers would be triggered by the crossing of a threshold by a macro variable.

References

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