Evolving Paradigms in Economic Policymaking

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BETTER POLICIES FOR BETTER LIVES

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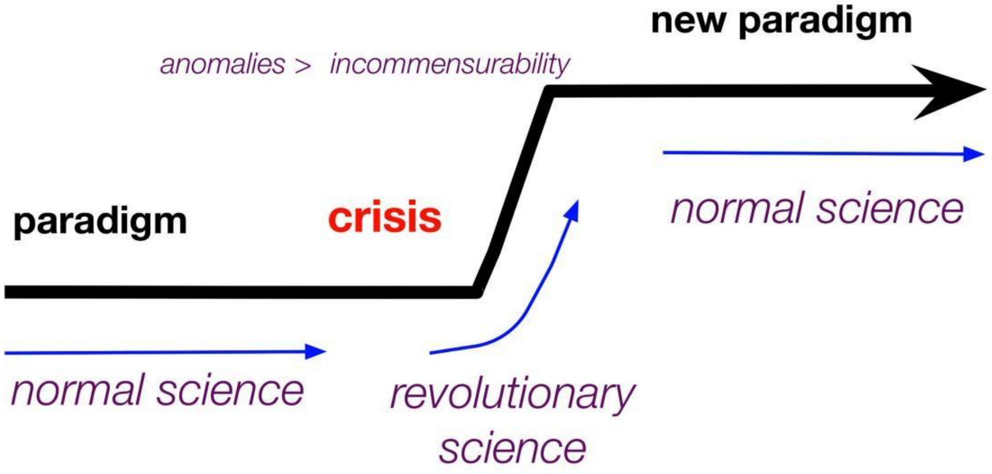
Introduction: The Paradigm Shift

What is a paradigm?

Set of norms (rules, principles or standards) accepted by a specific group on the basis of some established preconditions.

Ex.: the international monetary system dictates the rules that are applicable in international trade of goods, services and capital.



Introduction: The Paradigms in OECD Report

Summary:

- OECD Mission: to promote policies that will improve the economic and social well-being of people around the world.
- works with governments to understand what drives economic, social and environmental change

- Text addresses 4 main paradigms in economic policy:

1. 60-70s Demand Management Policies
2. 80s Medium-term Policies
3. 90s Rules-based Policies
4. 2000s Entry of emerging market economies

What are the causes/problems that led to a Paradigm Shift in the 60s/70s?

- Bretton Woods Agreement (Investopedia): 1944-1971, *currencies were pegged to the price of gold, and the U.S. dollar was seen as a reserve currency linked to the price of gold.*
- Fiscal and monetary policy instruments -> restore full employment, low inflation and external balances; 1960s -> rapid OECD growth
- Attempts to maintain unrealistic exchange rate parities -> rising external pressures
- 1970s – *inflation became a widespread problem*

Which methods/policies were used to implement that Shift?

• 1971 – pressure from international capital flows ends Bretton Woods system

• Smithsonian Agreement (1971) –multiple currencies pegged to the U.S. dollar, ineffective and short-lived

• 1979 – Establishment of the European Monetary System (EMS)

The EMS established a new policy of linked currencies between most countries in the European Economic Community (EEC) to stabilize foreign exchange and prevent large fluctuations in inflation among member countries and the European Currency Unit (ECU), the prelude to the euro

What were the consequences of these policies?

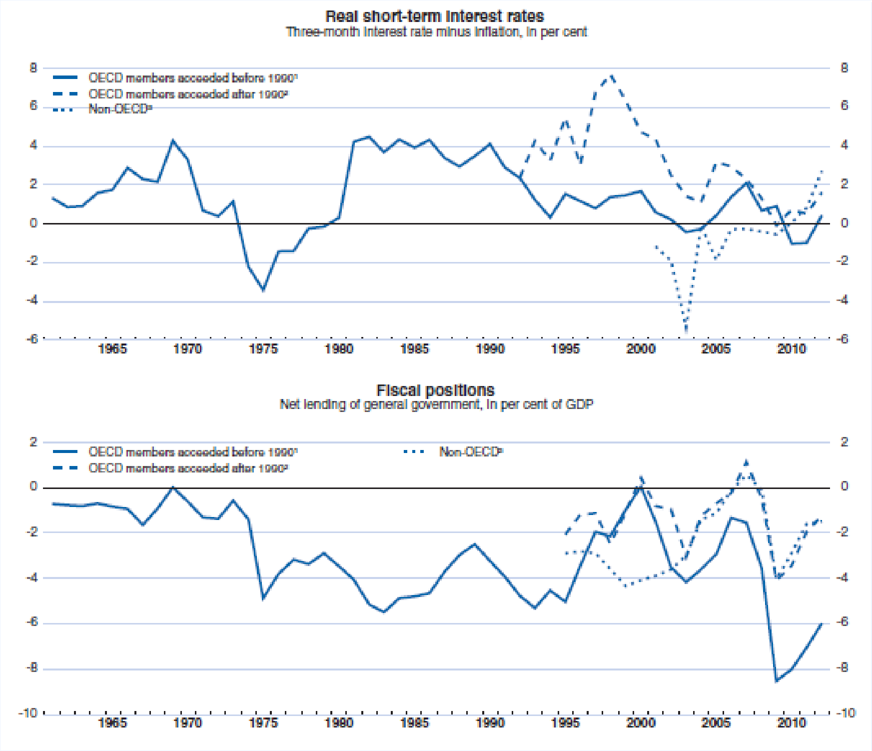
- Post-Yom Kippur War Oil Shock (1973) – Sharp fall of OECD output + increased inflation
    - **Stagflation**
- Bonn Summit (1978) – G7 uneasily consense on a policy package
    - Europe – multilateral trade negotiations within GATT
    - West Germany and Japan – fiscal stimulus measures
    - United States – raise domestic oil prices

Table 1. **Summary statistics**
Period averages

	1961-1972[1]	1973-1981
Real GDP growth		
United States	4.2	2.9
Japan	9.5	4.0
Euro area	5.1	2.8
Total OECD	5.0	3.1
Inflation[2]		
United States	2.7	7.9
Japan	5.7	8.9
Euro area	4.0	10.3
Total OECD	3.7	10.9
Unemployment rate[3]		
United States	4.9	6.7
Japan	1.2	1.9
Euro area	2.0	3.8
Total OECD	3.3	4.8
Current account balance[4]		
United States	0.4	0.1
Japan	1.5	0.1
Euro area		-0.6
Total OECD	0.2	-0.5
Fiscal balance[4]		
United States	-1.4	-2.2
Japan	1.0	-3.3
Euro area	-1.4	-3.4
Total OECD	-0.9	-3.0
Real short-term interest rate[5]		
United States	3.1	2.2
Japan	..	-0.5
Euro area	..	-0.4
Total OECD	..	-0.7

Breaking the back of inflation (1980s)

Figure 2. **Real short-term interest rates and fiscal positions**



1. See footnote 1 of Figure 1.
2. See footnote 2 of Figure 1.
3. See footnote 3 of Figure 1.

Source: OECD Economic Outlook 89 database.

StatLink http://dx.doi.org/10.1787/888932428918

What are the causes/problems that led to a Paradigm Shift in the 80s?

- Second oil shock (1979 – Iranian revolution)
  - Structural reforms: focus on efficiency, flexibility and competitiveness
    - Monetary policy:
      - Most OECD countries: limit growth of money supply
      - Europe: maintenance of exchange-rate parity (unchanged)
      - Result: real interest rates increased (Figure 2)
    - Fiscal policy (medium-term oriented):
      - Reduce/eliminate deficits
      - Stabilise/reduce debt-to-GDP ratios

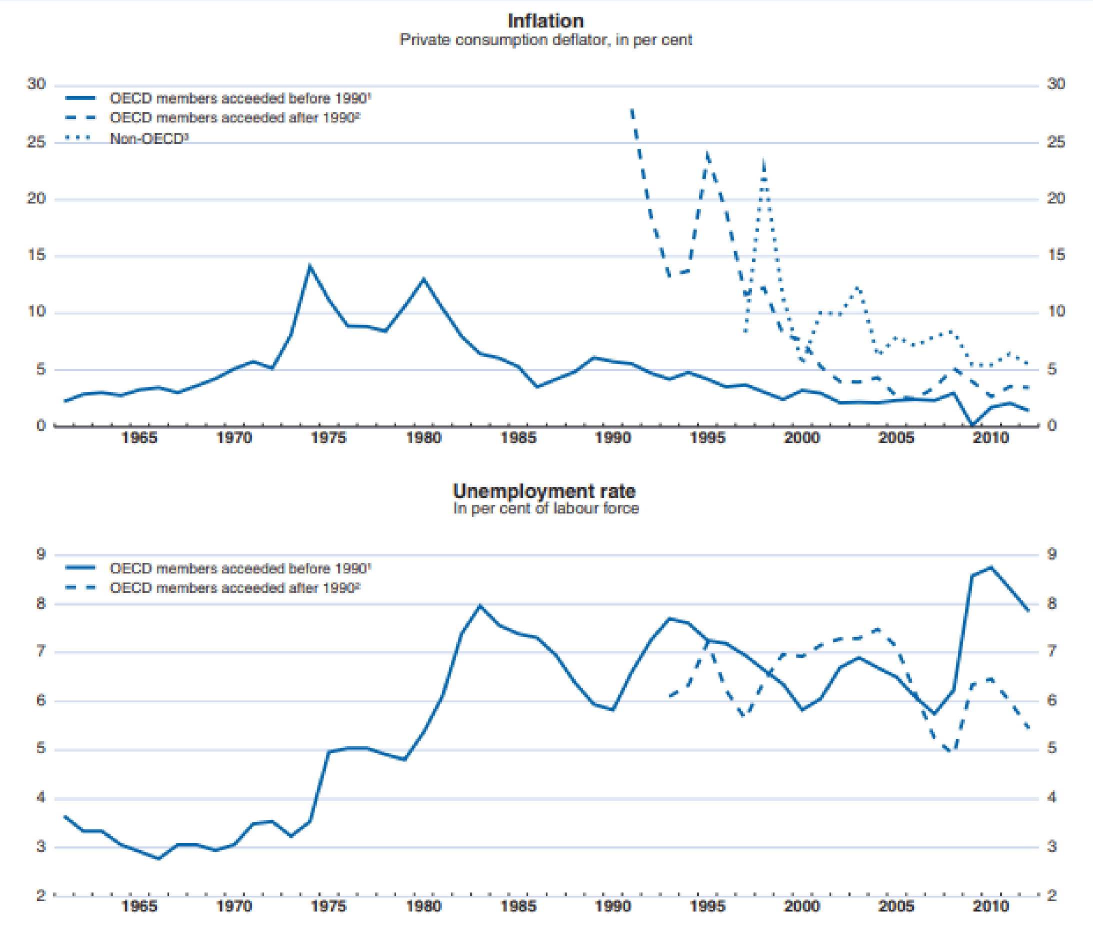
Which methods/policies were used to implement that Shift?

- From the structural reforms, we got:
  - *private-sector confidence revived*
  - recovery of profits
  - financial market liberalization
  - the 1992 Single Market (prospect)
- All of this combined led to:
  - recovery of OECD economies
  - rapidly increasing employment, rapidly decreasing unemployment rate
  - inflation levels decreasing
    - expectations were not met

What were the consequences of these policies?

- Monetary expansion did not handle 1987 stock market crash
- Unsustainable exchange rate targets; **Mundell-Fleming model verified**
  - *If capital controls are removed a conflict between pegged exchange rates and monetary policy autonomy would result.*
- Deregulation of domestic financial markets + Increase in global capital flows
  - Direct inflation targeting (monetary policy framework)
  - Solution: through international economic co-operation and intervention, re-align exchange rates and co-ordinate monetary policies

Figure 3. **Inflation and unemployment rate**



What are the causes/problems that led to a Paradigm Shift in the 90s?

Main driver of Paradigm Shift: fiscal policy rules failed to provide incentives for building up buffers in good times and the rise of private sector imbalances (sovereign debt crises).

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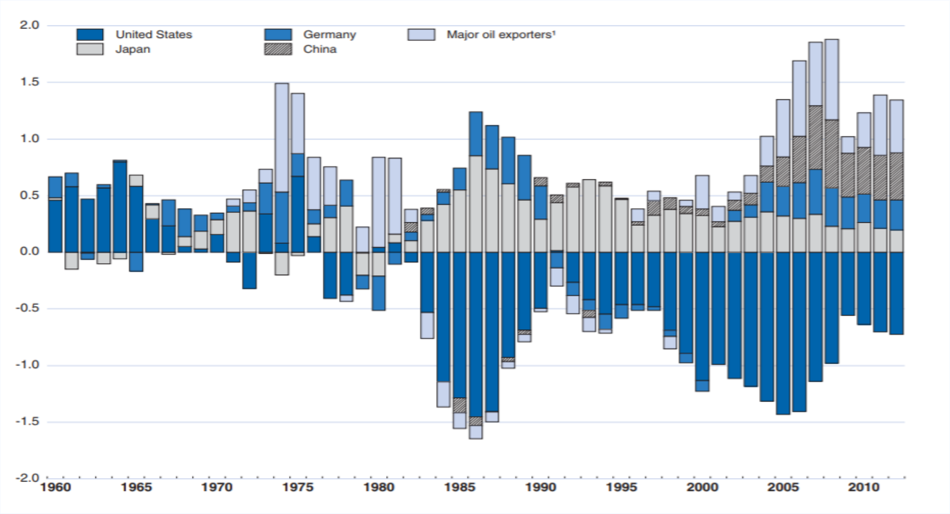
Figure 4. **Global imbalances**

Current account balance, in per cent of world GDP



1. Refers to Saudi Arabia before 1992.

Source: OECD Economic Outlook 89 database; OECD Economic Outlook 21 database; and IMF, International Financial Statistics.

StatLink http://dx.doi.org/10.1787/888932428937

Which methods/policies were used to implement that Shift?

Structural reforms: are all government-driven reforms that improve the functioning of the economy with the aim of leading to higher long-term GDP.

3 main channels:

- Productivity
- Employment
- Potential output in the long-run

Implementation in the EU:

- Reforms that facilitate the cross-border integration of product markets
- Reforms that increase the flexibility of wages and employment
- Reforms that help economies to recover after a recession

What were the consequences of a rules-based policymaking?

Pros

- Independence of Central Banks from the Government (no more time inconsistency)
- An inflation target
- An expenditure ceiling for the public sector

Cons

- Short-run costs: price and wage rigidity
- Very big shocks: supply vs. demand
- Hard transition period to accommodate

What are causes/problems that led to a paradigm shift in the 2000s?

- Increasingly integrated world economy
  * Removal of trade barriers * Liberalisation of capital flows
  * Spread of new technologies * Fall of the Iron Curtain

- Repetition of bubbles and busts (e.g. Dotcom crisis)
  - Macroeconomic origins & misguided financial innovation
  - Weaknesses in supervision and regulation
  - More risk taking (housing and mortgage market as main attractor)

Which methods/policies were used in this paradigm?

General:

- “Rules-based, forward-looking & stability-oriented national macroeconomic policies” → become more predictable & help to anchor expectations

Specific:

- Monetary policy: Price stability by independent central bank (2% inflation rate)
- Fiscal policy: Stabilizing public finances or reducing public debt and deficits
- Structural policy: Foster long-term economic growth, improve labour market outcomes and enhancing the resilience of economies

What were the consequences of these policies?

Monetary policy:

- Low and stable inflation & well-anchored expectations, but role of globalization not sufficiently recognized

Fiscal policy:

- Favourable cyclical developments masked underlying public finances
- Fiscal rules failed to provide incentives to build-up sufficient reserves in good times

Structural policy:

- Little international coordination on policy choices
- Cross-country imbalances in savings and investments
- Limited progress in key international reforms

What were the consequences of these policies?

General:

- Systemic risk potential not effectively monitored
- Policy decisions failed to incorporate the implications of::
    - Rapid pro-cyclical growth in financial leverage and risk taking
    - Concentration of risk
    - Increasing potential for cross-border and cross-market transmission of economic and financial shocks

Small corner of US financial markets → Global financial crisis (2008)

Key messages

- Economic policy making implies trade-offs and seemingly good policies may not have the intended results.

- Continuous evolving paradigm shifts: as society undergoes cultural & technological changes, there is the need to challenge the old paradigms.

- Systemic issues can eventually build up to a crisis, even if they seem innocent at first (domino effect).

Keynesian paradigm (1960-1980) (60s & 70s)

- Problem:
  - Unsustainable fixed exchange rates (gold convertibility)
  - Demand management could not respond properly to the oil shock

- Objective:
  - Stimulate the aggregate demand
  - Restore full employment, low inflation and external balances

- Instrument:
  - Increase public spending
  - Regulate the exchange rates

Supply-oriented management (1980-1990) (80s)

- Problem:
  - Stagflation (Stagnation of the economy/recession and inflation)

- Objective:
  - To lower the inflation
  - Increase output
  - Increase employment

- Instruments:
  - Supply-oriented management
    - Monetary policy: Limit growth of money supply
    - Fiscal policy: Reduce deficit and debt-to-GDP ratios
  - Structural reforms: financial market liberalization

Structural reforms in (1990-2000) (90s)

- Problem:
  - Rise of Public Debt and Fiscal Imbalances

- Objectives:
  - Improving the effectiveness of fiscal policy with rules-based policymaking

- Instruments:
  - Structural reform
    - Increasing cross-border integration
    - Flexibility of wages and employment
    - Ability for economic recovery after recessions

Emerging Market Economies (2000s)

- Problem:
  - Systemic risks arising from leverage
  - Increasing financial globalization for the transmission of shocks across borders

- Objectives:
  - Price stability (inflation 2%) (monetary)
  - Attain and maintain sound public finances (fiscal)
  - Improving longer term growth & improve labour market outcomes (Structural)
  - Improving resilience to shocks (Structural)

- Instruments:
  - Policy interest rate & communication policies (monetary)
  - Stabilizing or reducing public debts and deficits with automatic stabilizers (fiscal)
  - Policies to improve human capital and innovation (structural)
  - Easing of product and labour market regulations (structural)