Economic Policy & Business Activity

Evolving paradigms in Economic Policy Making Pt. 2

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The Text

- The text makes a clear division of the pre and post-crisis paradigms.
- The first part comprehends a thorough analysis of the pre crisis paradigm shifts.
- The second part explains the economic policies employed to overcome the crisis and how the paradigm has changed as a consequence.
- As a whole, stresses why paradigms fail, why economic policy is not a one-size-fits-all activity and why fiscal and monetary policies do need the support of structural reforms.

OECD
BETTER POLICIES FOR BETTER LIVES

Paradigm Shifts

60s & 70s
Demand Management
+
Fixed exchange rates

1980s
Supply-oriented management
+
Structural reforms

1990s
Structural reforms
+
Rules-based policy making

2000s
Supply-side structural policies
+
Rules-based policy making

2008
?

Key Questions

1. Which Economic Policies were employed to prevent a second Great Depression?

2. What was the policy exit strategy?

   2.1. What elements of the previous paradigm were preserved?

   2.2. What new elements were added to the new paradigm?

3. How can different policies across the globe coexist as to seek economic stability and growth for the future?

A Crisis Paradigm

The Keynesian Model of Active Demand

- Fiscal and monetary policy stimulus.

Non-conventional measures:

- Provisions of unlimited liquidity to the banking system.

NEW CHALLENGES - UNCERTAINTY

A Crisis Paradigm

- **Lowering policy interest rates and implementing fiscal stimulus**
  - Provision of credit;
  - Funding guarantees and liquidity to the financial system;
  - Bank recapitalization using public funds;
  - Deposit guarentee extensions.

Policymaking under uncertainty

- Uncertainty about slack and potential output;
- Uncertainty about the impact of monetary policy;
- Uncertainty about the impact of fiscal policy.

New paradigm

Main objectives:

- Eliminate the slack in the economy;
- Restore inflation levels;
- Establish sound Public Finances;
- Establish resilient financial markets.

New paradigm

Main elements:

- Micro & Macro prudential policies
- Reforming Fiscal Policy
- Adjustment of the monetary policy
- Structural reforms
- International co-ordination

Micro & Macro-prudential Policies

Micro-prudential Policies

Ensuring Financial institutions have sufficient capital and liquidity buffers

- Ending with the possibility of keeping risks off-balance
- Deal with incentive problems embedded into remuneration systems
- Create financial reforms to track down pension funds, insurance and others

Macro-prudential Policies

Guard against pro-cyclical build up financial imbalances in the economy

- New lending rules - higher margins
- More regular, systemic and harmonized stress tests of banks

Monetary policy framework

Key question: Should monetary policy lean against price bubbles or simply clean up after it has burst?

Pre-crisis view
Clean up

1. Bubbles are hard to identify;
2. Leaning May un-anchor inflation expectations.

Post-crisis view
Lean against

1. Due to rigorous crisis;
2. Specially when anchored by rapid credit growth.

When bubbles are identified, macro-prudence offers better tools

Central bank

Should incorporate financial stability considerations in it's policy decisions

Monetary policy framework

Inflation targets should be raised above the widely accepted 2% mark

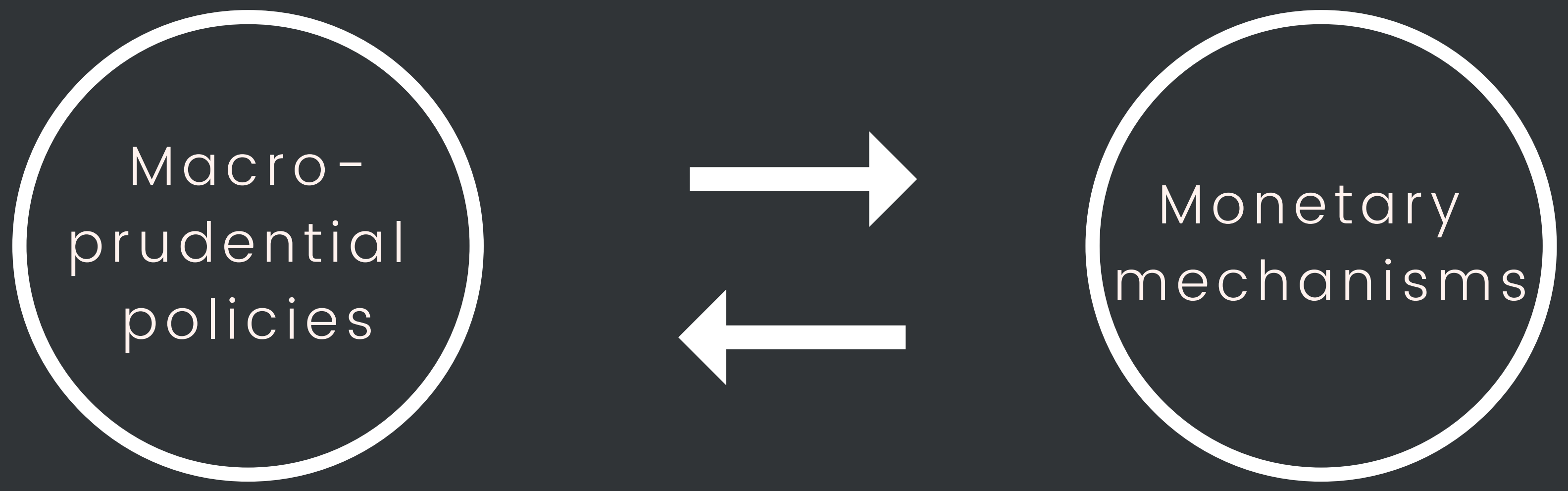
Better conditions to react to adverse shocks
Enhance Wage Flexibility
Loss of Central Bank's credibility

Establish the price level

Target is more precise
Quicker response
Riskier

Monetary policy framework

Central Bank must leave unconventional methods used within the crisis and act, again, in order with the conventional monetary policies.



- Combining these two types of policies in a single institution – better coordination.
- Separate institutions – Better accountability

Fiscal policy framework

Substantial fiscal consolidation is required by spending pressures related to health care, long-term care and pensions.

Sustainable	Transparent
Predictable	Counter-cyclical

In the future, fiscal outcomes will be influenced by the liabilities previously incurred during the crisis to rescue financial institutions

Fiscal policy framework

Examples of Fiscal Policies:

- Mid-term expenditures rules
- Incorporating expenditures plans
- Ceilings to complement deficit
- Save unexpected revenues for potential downturns

Fiscal policy framework

Fiscal rules should be:

- Binding in normal times (1);
- Sufficiently flexible in exceptional times

(1) Importance of establishing an independent fiscal council in order to raise the political cost of deviating from fiscal rules.

Structural Reforms

The following reforms were employed as to overcome problems of permanent reduction in output aligned with high levels of unemployment

1. Labor market reforms - ease the swift return to work
2. Fiscal consolidation reforms - decrease budget pressures
3. Ease rigidites of labor and product markets - more resilient to adverse shocks
4. Develop social welfare systems with Asia - address global imbalances

Structural Reforms

- 5. Encourage capital spending - reduce account surpluses
- 6. Removal of policy distortions that encourage consumption - increase household savings
- 7. Make borrowing money more accessible - to boost investment and consumption

International co-ordination & co-operation

Mechanisms need to be found to allow different policy settings to co-exist:

1. Strengthen prudential frameworks - such as G20 framework

2. Strengthen International monetary systems- ensure exchange rate adaptability

3. Control flows of capital to emerging economies - avoid unecessary LR risks

Wrap-up

POST-CRISIS PARADIGM

Monetary Policy

Price stability

Fiscal Policy

Sustainable balances

supply-sided structural reforms

Fiscal Consolidation

Micro & macro prudential policies

International co-operation and co-ordination

Conclusions

- Even when everything works fine - pre-crisis scenario - paradigms should be adapted and financial systems & institutions revised.
- The state should lean against bubbles, not just clean-up the mess;
- All economic policies should be coordinated;
- Structural policies are crucial to attain goals that fiscal and monetary policies alone cannot.
- Regulation and financial supervision are required in a globalized financial system;

Thank you