Evolving Paradigms in Economic Policy Making

Part 2

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A brief recap...

60s & 70s	80s	90s	2000s
Keynesian paradigm	Supply-oriented Management Paradigm	Structural Reforms Paradigm	Emerging Market Economies

And Today...

2008

Crisis
Paradigm

And after...

Post-crisis
Paradigm

How the Governments Reacted to Crisis

During the meeting of G20 in April 2009, they decided to:

- Apply massive fiscal and monetary stimulus

- Support the financial institution through governments and central banks

Unconventional Policy Measures

- Moving troubled assets to new companies
- Providing credit
- Funding guarantees and liquidity
- Bank recapitalization using public funds

Dramatic results on unemployment and inflation

Policymaking Under Extreme Uncertainty

Nowadays, information regarding the state of the economy is available everywhere. However, many uncertainty still persist:

- About slack and potential output
- About the impact of monetary policy
- About the impact of fiscal policy

Policy Exit Strategy

Exiting the crisis in OECD will take several years. There are many challenges to face:

- Eliminate slack in the economy
- Restore an appropriate inflation level
- Establish sound public finances and resilient financial markets

Policy Exit Strategy

- Challenge of monetary policy
- Challenge of fiscal policy

Emerging Markets Economies

- Withdraw of fiscal stimulus to avoid bubbles

- Structural policies should aim to enhance productivity and achieve growth

Post-crisis Paradigm

- Strong sustainable growth
- Price stability
- Sustainable public finances
- Co-ordination of economic policies to reinforce each other

Micro-prudential Policies

To ensure that financial institutions have enough capital buffers:

- New required minimum levels of bank capital defined by Basel Committee
- Reform of liquidity requirement

Reduction of economic cost of financial crises

Macro-prudential Policies

Developed to guard against cyclical build-up of financial imbalances:

- Contingent add-ons to micro-prudential buffers
- Procedures for resolution of cross-border financial institution
- Higher margin requirements
- Systemic stress test of banks

Reforming Monetary Policy Framework

During the crisis was reopened the debate whether monetary policy should:

Lean against asset price bubbles

or

Clean up after a bubble

Pre-crisis view:

clean up is the best solution

- Difficulties to identify bubble in real time
- Leaning could un-anchor inflation expectations

Post-crisis view:

- Due to the harshness of the crisis, leaning against asset price bubbles began to collect consent

- When bubbles can be identified, macro-prudential regulation offer better tools to prevent them

Learning from the crisis

- inflation target should be raised above the accepted 2%

Unconventional monetary policy adopted was successful in:

- Improving conditions of financial markets
- Stabilizing the economy

Co-ordination between macro-prudential and monetary policies

- Combined in a single institution

Easier to manage

- Separate institutions

Better accountability

Two other means to reduce the risk of a new crisis:

Improve the fiscal framework

and

Settlement of structural reforms

Improve the Fiscal Framework

- Consolidations are needed in the long-run
- Improvement of the expenditures rules
- Establishment of a fiscal council
- Manage strongly sovereign debt

Settlement of Structural Reforms

What are structural reforms?

- Measures that change the fabric of an economy, the institutional and regulatory framework in which businesses and people operate

- Designed to ensure the economy is fit and better able to realise its growth potential in a balanced way

Settlement of Structural Reforms

Different use of structural reforms according to OECD:

- Growth-enhancing
- In labour and product market
- Impact on the global imbalances

International Cooperation

Nations will have to cooperate to find a set of policies that can coexist and allow economic stability and international growth

G20 has the role of strengthening growth prospects and helping to achieve more suitable fiscal positions

International Monetary System

Appreciation of the currencies of the emerging market economies:

- Fixed nominal exchange rate → changes in wages and prices
  - ‼ Loss of control on inflation
- Variation in exchange rate
  - ‼ Increase of risks in case of excessive volatility

Dutch disease

Negative consequences of substantial capital inflows

strong appreciation of the currency

How can it be fought?

- Establishment of an adequate mix of macroeconomics policies
- Reinforcing macro-prudential frameworks
- Affecting capital inflows through structural policies
- Applying Capital restriction

Conclusions

Some parts of the previous paradigms remained valid:

- Monetary policies to obtain price stability through interest rates and communication
- Fiscal policies to achieve sustainable public finances, medium-term oriented
- Growth enhancing structural reforms, also to help governments' fiscal consolidation

Conclusions

After the crisis, more emphasis were put on other aspects:

- Interdependences between all the strands of economic policies gained relevance
- Micro and Macro-prudential policies, with a scope of regulation and supervision
- International co-ordination and co-operation aimed at reinforce the effects of economic policies

Thanks for your attention