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A New Macroeconomic Playbook

Ahead of the conference on Macro and Growth Policies in the Wake of the Crisis, which was held on March 7-8 in Washington DC, IMF Chief Economist Olivier Blanchard shared his thoughts about how the crisis has prompted a reexamination of macroeconomic principles (see http://www.imf.org/external/np/seminars/eng/2011/res/index.htm for details on the conference and Mr. Blanchard's full remarks).

Before the global economic crisis, mainstream macroeconomists had largely converged on a framework for the conduct of macroeconomic policy. The framework was elegant, and conceptually simple. Caricaturing just a bit, it went like this:

The essential goal of monetary policy was low and stable inflation. The best way to achieve it was to follow an interest rate rule. If designed right, the rule was not only credible, but delivered stable inflation and ensured that output was as close as it could be to its potential.

This was achieved by setting the key policy rate that then affected the term structure of interest rates and asset prices, and then to aggregate demand. One could safely ignore most of the details of financial intermediation. Financial regulation was outside the macroeconomic policy framework.

On currencies, countries could set an inflation target and float, or instead choose a hard currency peg or join common currency areas. In general, in a world in which central banks followed inflation targeting, there was no particular reason to worry about the level of the exchange rate or the current account balance. Certainly, attempting to control exchange rates through capital controls was undesirable. And multilateral coordination was not required.

Fiscal policy had a limited role at best, at least in the short run. With the right use of monetary policy, it was not really needed. Automatic stabilizers, such as unemployment benefits, would kick in during downturns, but discretionary policy was more likely to be misused than used well. The focus had to be on the medium run, and on fiscal sustainability.

These were simple principles, and they seemed to work. From the early 1980s on, macroeconomic fluctuations were increasingly muted, and the period became known as the "Great Moderation". Then the crisis came requiring a wholesale reexamination of those principles. Here are some of Mr. Blanchard's ideas to guide the conversation:

Economic imbalances: Achieving stable inflation is good, but we can now see it does not guarantee stable output. Before the crisis, steady output growth and stable inflation hid growing imbalances in the composition of output and in the balance sheets of households, firms, and financial institutions, as well as growing misalignments of asset prices. These imbalances ended up being very costly. The question now is how best to address such imbalances. Should we think of macroeconomic policy as having three legs—monetary, fiscal, and financial—each with separate authorities? Or should we think of extending both the mandate and the set of tools of monetary policy to cover both output and financial stability? And, if so, what tools do we have and how do we use them?

Interest rates: Early in the crisis, central banks decreased policy rates, until they reached their lower bound—namely zero. From then on, interest rate policy could not be used to prop up aggregate demand, and central banks turned to both credit and quantitative easing. This raises many questions. First, would it have helped if nominal interest rates had been higher to start, giving more margin of maneuver to central banks? Put another way, should we revisit the low inflation targets, and the associated low average nominal interest rates, that central banks had adopted pre crisis? Second, are credit and quantitative easing policies just for exceptional times, or can they work and do they make sense in more tranquil times?

Fiscal policy: When interest rates reached the lower bound, fiscal policy came back to the fore. Going beyond automatic stabilizers, most countries adopted fiscal stimulus programs to increase aggregate demand, but debates about the size and even the sign of multipliers associated with different fiscal measures made clear how little work had been done on fiscal policy, and how much needed to be done. The large increase in debt since the beginning of the crisis (an increase which is overwhelmingly due to the loss of output and the implied loss in revenues rather than to the fiscal stimulus programs themselves) also raises many issues. What levels of public debt should countries aim for?

Capital flows: The crisis triggered very large capital outflows, often because of the need by foreign financial institutions to repatriate funds in a hurry. More recently, capital has gone back to emerging market countries, sometimes with such force as to trigger complaints of 'currency wars,' leading to intense discussions about capital account management. How should countries react to large capital inflows? If they want to mute their effect for example, when should they build up reserves and when should they use capital controls? Should there be international rules of good behavior?

International monetary system: Should benign neglect determine the coordination of monetary policies across countries? Should there be international rules not only with respect to capital controls, but with respect to reserve management, and monetary policy in general? Should countries be free to run the current account deficits or surpluses they want, or should there be restrictions on what they should do? Does export-led growth remain an acceptable strategy from a multilateral point of view?

Many interesting issues that over time will reshape the boundaries between markets and government intervention and sovereignty and multilateralism.

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