



Rethinking Macro Policy II: First Steps and Early Lessons

Olivier Blanchard

Chief Economist, International Monetary Fund

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Rethinking Macroeconomic Policy

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The IMF has just hosted a second conference devoted to rethinking macroeconomic policy in the wake of the crisis. After two days of fascinating presentations and discussions, I am certain of one thing: This is unlikely to be our last conference on the subject.

Rethinking and reforms are both taking place. But we still do not know the final destination, be it for the redefinition of monetary policy, or the contours of financial regulation, or the role of macroprudential tools. We have a general sense of direction, but we are largely navigating by sight.

I shall take six examples, inspired by the conference. (More developed, albeit preconference, thoughts are given in [Rethinking Macro Policy: Getting Granular](#), written with Giovanni Dell’Ariccia and Paolo Mauro.)

Navigating by sight. **Financial Regulation**

There is no agreed-upon vision of what the future financial architecture should look like and, by implication, no agreed-upon vision of what the appropriate financial regulation should be. You may remember the famous quote by Paul Volcker that the only useful financial innovation of the last 40 years has been the ATM. This is surely an exaggeration. But we are still unsure about the right role of securitization, the right scope for derivatives, the role of markets versus banks, and the role of shadow banking versus banking.

Still, we all agree that some things should change, and indeed policymakers are putting in place measures in the context of international or national initiatives. One example is the increase in required capital ratios. It may not be a panacea, but it surely can make the financial system more robust. Even so, however, I am struck by the level of uncertainty and disagreement about the effects of capital ratios on funding costs and thus on lending. Reasonable

people, such as Martin Hellwig and Anat Admati, argue that we are not so far from the Modigliani-Miller world, and banks can afford substantially higher capital ratios. Others (and not only bankers) argue that such ratios would instead destroy the banking industry.

Another example is capital flows and, by implication, the role of capital controls. I was struck by [Helene Rey's presentation](#), in which she showed how surprisingly meager the hard econometric evidence is on the benefits of portfolio flows. I was also struck by Stanley Fischer's rhetorical question: What is the usefulness of short-term capital inflows? Clearly, how we think about the scope of capital controls depends very much on the answer to these basic questions.

Navigating by sight. **The Role of the Financial Sector**

It has become a cliché to say that macroeconomic thinking understated the role of financial factors in economic fluctuations. Much analytical work has taken place over the past five years to reintroduce the financial system in our models. But we are not there yet. For example, is there a credit and financial cycle, separate from the business cycle, as [Claudio Borio](#) suggests? Or should we think of financial shocks as another source of disturbance and the financial system as just another source of amplification?

Was Stephan Gerlach right when he asked whether we should really reconsider all of macroeconomics for an event that may happen once every hundred years? Or, instead, are financial shocks and the financial system so central to macroeconomic fluctuations that the IS-LM model—which, as you will recall, does not include an explicit financial system—is not an acceptable port of entry into macroeconomics?

By implication, there is no agreement on how or even whether to integrate financial stability and macrostability in the mandate of central banks. Does it require a tweak to inflation targeting or much more radical rethinking? The intellectually pleasant position is to argue that macroprudential tools will take care of financial stability, so monetary policy can still focus on its usual business: inflation targeting. I read, perhaps unfairly, [Michael Woodford's](#) discussion at this conference as suggesting that the crisis should lead us to

shift from inflation targeting to nominal income targeting without a major emphasis on financial stability. I am skeptical that this is the right answer. I think we have to be realistic about the role that macroprudential tools can play and about the fact that monetary policy cannot ignore financial stability. This brings me to my third point.

Navigating by sight. **Macroprudential Tools**

At our first Rethinking Macroeconomic Policy conference in 2011, macroprudential tools were, to use Andrew Haldane's phrase, very much the new kid on the block. It was clear that the two standard tools—fiscal and monetary policy—were not the right ones to deal with financial imbalances and risks. The question then was whether macroprudential policy was going to be the third leg of macroeconomic policy or just a crutch to help the first two.

We do not have the answer yet. But as more and more countries are using those tools, we are learning. I draw two lessons from the evidence and from the presentations today.

First, these tools work, but their effects are still hard to calibrate, and when used, they seem to have moderated rather than stopped unhealthy booms. This is also my reading from [Governor Kim's](#) presentation.

Second, by their nature, they affect specific sectors and specific groups, and raise political economy issues. This was clear from [Stanley Fischer's](#) presentation on the use of loan-to-value ratios in Israel.

1. Navigating by sight. **Governance and Allocation of Tasks Among Microprudential, Macroprudential, and Monetary Policy** (or, as Avinash Dixit called them, MIP, MAP, and MOP)

How should microprudential and macroprudential regulation be coordinated? It is sometimes said that they are likely to conflict. Conceptually, I do not see why they should: I see macroprudential as simply taking into account systemic effects and the state of the economy in thinking about bank regulation and the situation of each financial institution.

For example, I see macroprudential regulation requiring higher capital ratios from more systemically important banks or when aggregate credit growth appears too high. The question is how to work out the division of labor and the interactions between the two so that this is indeed what happens.

If not done right, it might mean that as a bust starts, the microprudential supervisor ignores systemic aspects and other events and asks for higher capital ratios, while the macroprudential supervisor rightly believes the opposite is needed. The United Kingdom's approach—the creation of a Financial Stability Committee that can impose capital ratios that vary over time and across sectors—seems like a good way to proceed. You can read more about this in [Andrew Haldane's](#) discussion of the issues.

How macroprudential regulation and monetary policy should be combined raises more complex issues. There is little question that each one affects the other: Monetary policy affects risk taking, and macroprudential tools affect aggregate demand. So policymakers need to coordinate.

Given that monetary policy surely must stay with the central bank, this suggests putting both of them under one roof at the central bank. But this in turn raises the issue of central bank independence. It is one thing to give the bank independence with respect to the policy rate; it is another to let it set maximum loan-to-value ratios and debt-to-income ratios. At some point, the issue of democratic deficit arises.

Maybe the solution is not so hard; namely, to give various degrees of independence to the central bank. [Stanley Fischer](#) gave us a marvelous analogy and pointed us toward the solution when he said that anybody who is married easily understands the notion of various degrees of independence. Again, the United Kingdom's approach, with its two parallel committees within the central bank (one focusing on monetary policy, the other on financial policy with a limited set of macroprudential tools, not including, for example, loan-to-value ratios) seems like a reasonable approach.

Navigating by sight. **The Sustainable Level of Debt**

The rate of fiscal consolidation depends, among other things, on what we think a sustainable level of debt is. Many countries are going to be managing levels of debt close to 100 percent of GDP for many years to come. There is a standard list of textbook answers as to why high debt is costly, from lower capital accumulation to the need for higher and distortionary taxes. I suspect the costs are elsewhere. I see two main costs.

The first is debt overhang. The higher the debt, the higher the probability of default, the higher the spread on government bonds, and the harder it is for the government to achieve debt sustainability. But the adverse effects do not stop there. Higher sovereign spreads affect private lending spreads, which in turn affect investment and consumption. Higher uncertainty about debt sustainability—and thus about future inflation and future taxation—affects all decisions. I am struck by how limited our understanding is of these channels. Reduced form regressions of growth on debt can take us only so far.

The second related cost is the risk of multiple equilibria. At high levels of debt, there may well be two equilibria: a “good equilibrium,” in which rates are low and debt is sustainable, and a “bad equilibrium,” in which rates are high and, as a result, the interest burden and the probability of default are higher. When debt is very high, it may not take much of a change of heart by investors to move from a good to a bad equilibrium.

I suspect that this phenomenon is partly behind the Italian and Spanish bond spreads. In this context, [Martin Wolf](#) asked a provocative question: Why are the spreads so much higher for Spain than for the United Kingdom? Debt and deficits are actually slightly lower in Spain than in the United Kingdom. No doubt, the overall economic situation of Spain is worse than that of the United Kingdom, but does this explain fully the difference in spreads? Could the answer lie in the difference in monetary policy? In the United Kingdom, investors expect the Bank of England to intervene if needed to maintain the good equilibrium, whereas they believe the European Central Bank does not

have the mandate to do so. These are central questions that we need to study more.

Navigating by sight. **Multiple Equilibria and Communication**

In a world of multiple equilibria, announcements can matter a lot. Take, for example, the case of the Outright Monetary Transaction program announced by the European Central Bank. The announcement of the program can be interpreted as having removed one of the sources of multiple equilibria in the sovereign bond markets; namely, redenomination risk—the danger that investors, assuming that a periphery country would leave the euro, ask for a large premium, thereby forcing exit from the euro in the process. The announcement has succeeded without the program actually having to be used.

From this viewpoint, the recent announcement by the Bank of Japan that it intends to double the monetary base is even more interesting. What effect it will have on inflation depends very much on how Japanese households and firms change their inflation expectations. If they revise them up, this will affect their wage and price decisions, and lead to higher inflation—which is the desired outcome in the Japanese deflation context. But if they do not revise them, there is no reason to think that inflation will increase much.

The motivation for this dramatic monetary expansion is primarily to give a psychological shock and to shift perceptions and price dynamics. Will it work, together with the other measures taken by the Japanese authorities? Let's hope so. But we are very far from the mechanical effects of monetary policy described in the textbooks.

I could go on. Indeed, there were many contributions and insights from the conference that I have had to leave out. The conference has left us with a clear research agenda. We at the IMF fully intend to take up the challenge.