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“Rethinking Macroeconomic Policy”

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Overview

The paper is basically divided in three parts:

1. A review of what we thought we know about Macroeconomic Policy before the crisis of 2008;
2. An identification of the aspects on which we were wrong;
3. An attempt to propose some key points for a new macroeconimic framework.

First Part

What we thought we knew before the crisis

Macroeconomic framework before the crisis

Monetary policy

One target: low inflation

One instrument: policy rate

Fiscal policy

Played a secondary role

Financial regulation

Outside macroeconomic policy framework

One target: stable inflation

ECB is based on German Central Bank.

The primary mandate is to maintain a stable inflation *(concept supported by New Keynesian model)*

Stable inflation is considered the optimal policy, because it provides the Zero Output Gap. *(Output Gap is the distance between the potential output and the real output)*

New Keynesian model: not using expansive monetary policy for short run gains in output and employment as that could raise inflationary expectation and cause problems for the future.

Low inflation

Increasing consensus that **inflation should not only be stable, but also very low.**

A potential problem of stable low inflation is that it could generate a **Liquidity trap**:

corresponding to **low average inflation is in fact low average interest rate**, and as a consequence **less room for expansionary monetary policy in case of an adverse shock** (as that interest rate can't be lowered more than to the zero level)

However, the danger of a low inflation rate was thought to be small

One instrument: policy rate

Monetary policy focused on the use of Policy Interest Rate, that represents the short-term interest rate that the Central Bank can directly control through appropriate open market operation.

Two considerations:

1. Real effects of monetary policy took place through interest rates and asset prices
2. All interest rates and asset prices were linked through arbitrage

This two assumptions give us the possibility to affect only current and future expected short rates: all the other rates and prices follow.

One can do this by using a predictable rule like the Taylor Rule.

The Taylor rule

$$i = \hat{\imath} + \alpha\,(\pi - \hat{\pi}) + \beta\left(\frac{Y - \hat{Y}}{Y}\right)$$

It's a monetary policy rule that stipulates how much the Central bank should change the nominal interest rate in response to variation in:

1. INFLATION
2. OUTPUT
3. OTHER ECONOMIC CONDITIONS

In particular the rule stipulates that for each 1% increase in inflation the Central Bank should raise the nominal interest rate by more than one percentage point.

Limited role for fiscal policy

During 1960's and 1970's policymarkers used Fiscal and Monetary policies as two instrument to achieve two different targets, internal and external balance.

On the contrary, from the '80s, **fiscal policy took a backseat to monetary policy** because:

- Wide **skepticism on the effects of fiscal policy**
- If monetary policy could maintain a stable outputgap there was **no reason to use another instrument**
- Lags in the design and implementation of fiscal policy caused the **fiscal measures to arrive often too late**
- Fiscal policy were distorted by political constraints

Financial regulation: not a macroeconomic policy tool

Financial regulation and supervision on institutions and markets were ignored in their macroeconomic implications.

Little thought was given to using regulatory ratios such as loan to value ratios or capital ratios.

On the contrary, given the enthusiasm for financial deregulation, **the use of regulation was considered to be improper for the functioning of credit markets.**

The Great Moderation

It's a period started in 1980's in which a coherent macro framework had been achieved thanks to the steady decline in the variability of output and inflation in most advanced economies.

We have to say that **there is still an ambiguity as how much this decline is due to a result of smaller shocks or due to an improvement in the policy**.

In reality improvements in inventory management and the rapid productivity growth and trade integration of China and India played an important role.

Second Part

What we have learned from the crisis

Stable inflation may be necessary, but is not sufficient

Core inflation was stable in most advanced economies until the crisis started. But someone (in retrospect) argued that core inflation was not the right measure of inflation *(as oil or housing prices should have been accounted).*

Nevertheless, the crisis started in 2008, the aggregate demand collapsed and most central banks quickly decreased their policy rate close to zero.

Therefore in reality the behavior of inflation is much more complex: no single index can explain the entire economic situation.

Low inflation limits the scope of monetary policy in deflationary recession

The zero nominal interest rate bound has proven costly. **Higher average inflation and so higher nominal interest rates to start with, would have made it possible to cut interest rates more.**

Financial intermediation matters

- Markets are segmented with **specialized investors** operating in specific markets; they are usually **linked through arbitrage**, but sometimes, for several reasons, **some investors could leave the market and as a consequence the effect on prices could be large.**

- Another problem that the crisis discovered was the one of so called "bubbles", leading assets to deviate from fundamentals only for speculative reasons.

In order to prevent these problems, interventions from Central banks could be important.

Countercyclical fiscal policy is an important tool

The crisis has returned fiscal policy as an important tool for macroeconomic policy, and that's for two reasons:

1. Monetary policy had reached its limits,
2. The recession was expected to be long lasting, so fiscal stimulus would have had long time to benefit the economy.

The crisis showed also the importance to have a "fiscal space":

- some advanced economies that entered the crisis with high levels of debt have had limited possibility to use fiscal policy
- similarly those emerging markets that had used a strong fiscal policy in order to improve the consumption and attract investment now are forced to cut spending and increase taxes .

On the contrary other emerging markets entered the crisis with lower levels of debt so allowed them to use fiscal policy more aggressively.

Third Part

Key points for the design of a new macroeconomic framework

Until now we have examined the flaws of the existing macroeconomic framework

From now on, then, we'll focus on the key points that a new strategy should follow

As a starting point, we must say that **most of the major conclusions on macroeconomic theory are still valid.** The main objectives remain:

- **Stable inflation**
- **Stable output gap** *(= Real Output – Potential Output)*

But the crisis has teached that there are **other important factors to consider**.

Policy makers should use a **wider variety of instruments** than what they used to do before the crisis

The challenge becomes:

- Choosing the **right combination of instruments and targets**
- Determining the **subjects that should have the power to govern and implement the different strategies**

So, to examine the new potential framework, **each of the following slides will concentrate on one of the major topics** considered important by the authors

Inflation Target

The question here is:

should policymakers aim for a **higher target inflation rate** in normal times (for example, higher than the current 2% range), in order to **increase the room for monetary policy interventions**, in response to possible shocks in the real or financial economy?

(remembering the correlation between inflation and nominal interest rate, and that a higher nominal interest rate would leave more room to be lowered, in order to fight a recession with an expansive monetary policy intervention).

There are **disadvantages** in keeping a higher inflation rate:

The main one is that **inflation is clearly distortionary**, and the **tax system is not inflation neutral**, so it should be properly corrected; but it would be **hard to fix all the distortions.**

At the end, the question remains, as the authors don't have a final response on whether the costs of the inflation are outweighted by the advantage of having potentially more room for monetary policy

Combining Monetary and Regulatory Policy

The main instrument of Monetary Policy, **the Interest Rule (= *controlling the interest rate*) is not enough**

There are **other effective instruments at the Policymaker's disposal, the Regulatory Tools**

examples: capital ratios (≈ equity/assets) on debt, or loan to value ratios (loan/value of the asset purchased) on housing prices,..

The better solution seems to use the interest rate to deal with aggregate activity and inflation, and to **expand the range of regulatory interventions to deal with specific subjects** regarding financing, asset pricing, or the output composition

How can this coordination between the Monetary Authorities and the Regulatory Authorities be achieved?

Among all the alternatives, perhaps the better solution is to **centralize these responsibilities within the Central Banks**

Foreign Exchange Interventions

Normally, Central Banks state that they consider the exchange rate only for its impact on the primary objective, inflation

This may be true for large and advanced economies, but probably **not for small economies.**

Large fluctuations in exchange rates (due for example to strong shifts in capital flows, as we saw during the crisis) **can cause big problems in economic activities, financial stability and output.**

For example, a large appreciation may squeeze the tradable sector, and make it difficult for it to grow back.

Tools like **reserve accumulation and interventions of sterilization, when properly regulated, could help to control the exchange rate target**, leaving domestic objectives under the control of the classic interest rate method.

Liquidity Provision

The crisis has forced the Central Banks to step up and **extend the normal scope of their interventions**, that usually was as lenders of last resort.

In fact, they intervened directly (with direct purchases) and indirectly (through acceptance of assets as collateral) in a wide range of asset markets

The question is: **should these policies be kept even in calm times?**

Public liquidity interventions **can be helpful when private investment slows down**.

On the other hand, the lack of private investment can reflect solvency problems, and providing liquidity **can therefore constitute a risk for the Balance Sheets.**

This aspect too, therefore, should be specifically regulated

Creating more Fiscal Space

A key lesson from the crisis is that it could be **extremely important for countries to have enough space for Fiscal Policies interventions.**

(And this is in analogy with what we've said about the nominal interest rate room level, regarding Monetary Policy)

Enough space for Fiscal Policies means that **deficits should be kept at a much lower level** than now, **in order to allow more prompt and strong interventions** by the governments when the economic conditions really require that

This is a **problem that concerns several countries**, and unfortunately **Italy is in the top list.**

The recipe, therefore, should be:

- **reduce debt ratios substantially**
- **provide credible medium-term fiscal frameworks**

Automatic Stabilizers

Automatic Stabilizers are **specific rules that allow some taxes or transfers to vary according to the state of the economic cycle.**

For example, we can think about:

- temporary tax policies targeted to low income households
- tax policies affecting firms *(i.e. cyclical investment tax credits,..)*
- temporary transfers targeted at low income households

As a big problem with discretional fiscal measures is that they often come too late to fight recessions, in the opinion of the authors **these transfers could be important, because they could be effective more rapidly** than the classic fiscal policies

Conclusions

First of all, it's important to recognize that **the crisis we're still experiencing has exposed some flaws** in the macroeconomic framework

But **not everything we thought was wrong**.

On the contrary, **the main goals to achieve still remain stable inflation, and stable output gap.**

There are **other important targets** that policymakers must look at, and there are **also potentially more instruments** to use.

Among them, we remember the **Regulatory Tools**, that should be used **in combination with the classic Monetary Policy**; or better **Automatic Stabilizers in support to Fiscal Policy**

Finally, we should repeat the **importance of keeping a lower public debt** in good times, **to be able to act with force during the periods that require strong interventions**