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What Have We Learned: Macroeconomic Policy after the Crisis

Edited by George A. Akerlof, Oliver J. Blanchard, David Romer and Joseph E. Stiglitz

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In 2008, the global economy prepared itself for the worst economic recession since the Great Depression. After an unprecedented stimulus of $787 billion from the U.S. government and various innovations in economic and financial policy, we have only just begun to see significant recovery in some countries.

Adair Turner, one of the contributing authors, quoted Queen Elizabeth II by asking: "Why did no one see it coming?" While we cannot expect economists to have perfect foresight, we might reasonably ask the following questions: How can we avoid another crisis in the future? How should we respond to crises should they arise? To answer these questions, influential economists, central bankers, policymakers and experts from around the world gathered at the IMF-organized conference, *Rethinking Macro Policy II: First Steps and Early Lessons* in 2013. *What Have We Learned* is a collection of essays, documenting ideas that emerged from this discussion. Effectively, it is a review of our current knowledge of macroeconomics, refined by observations made during the 2008 financial crisis. While many books have since been written about the crisis, *What Have We Learned* is among the few that offer a rare glimpse into the minds of the very policymakers and economists, who steered the global economy through these tumultuous times. A word of caution: the general reader might find the book an esoteric piece. This review attempts to break down some of the ideas in *What Have We Learned*, and present them in bite-size portions.

Monetary policy was the first to be examined.[1] One factor made the 2008 financial crisis

[1] Monetary policy and fiscal policy are the two primary tools that policymakers use to affect economic outcomes on the national level. Fiscal policy includes taxation and government spending. On the one hand, fiscal policies require approval from some political process, and can take years to implement. Economists have a term for this, called "fiscal lag". On the other hand, monetary policy is controlled by a politically independent institution: the central bank, which can generally approve and implement policies with little delay. Hence, in the 2008 financial crisis (and in general), monetary policy offered quick policy responses to changing economic circumstances.

different for monetary policy – policy rates are at the zero lower bound, and cannot be further lowered.[2] In economic jargon, the policy rate is already so low that it is constrained by the *liquidity trap*, such that central banks cannot use their traditional tools to stimulate the economy. In simpler terms, monetary policy has become ineffective.

Keynes predicted this phenomenon well back in the 1930s, but it was not until recently that it became a problem for monetary policy. This was hence a new challenge for central banks. In response to the failure of conventional monetary policy, several central banks, such as the Federal Reserve and the Bank of England, resorted to an unconventional monetary policy measures, more commonly known as *quantitative easing*.[3]

Challenging this view of monetary policy, Lorenzo Bini Smaghi, a contributing author, raises an important paradox. In targeting inflation (i.e. keeping inflation and interest rates low because they generally go hand in hand), central banks create more relaxed lending conditions, which potentially create asset-price bubbles. And when these asset-price bubbles burst, the financial market destabilises. In fact, the burst of U.S. housing bubble in 2006 is one of the factors that gave rise to the 2008 financial crisis. Hence, the paradox: in stabilising the crisis, central banks are also creating conditions that undermine financial stability, and increase risks of future crises. This is perhaps one of the most important lessons that we learned from this episode.

Hence, as the 2008 financial crisis ran its course, economists turned their attention to yet another new tool that holds promise for financial stability. Andrew Haldane – Chief Economist at the Bank of England – wrote the following:

Existing monetary policy theory states that central banks can stabilise the economy by influencing the *policy rate* – a term for the interest rate at which banks can borrow from the central bank over a very short period of time, typically overnight. This is why the policy rate is sometimes referred to as the *overnight rate*. During recessions, central banks would lower the policy rate, and this is believed to stimulate the economy. The mechanism is that commercial banks can in turn lend out more money at a lower interest rate, thus encouraging spending and investment. Many central banks use *inflation targeting* to decide the exact level of policy rates. This means that Central Banks decide on the level of inflation optimal for economic growth, and adjust the policy rate to achieve this inflation rate. True to their economics training, central bankers around the world swiftly cut their policy rates in response to the economic downturn.

[2] Central banks can technically set policy rate below. This is effectively a tax on banks for going beyond their reserve requirements. Central banks that have experimented with negative interest rates include the European Central Bank, Riksbank (Swedish National Bank) and Nationalbanken (Danish National Bank). Central bankers have traditionally avoided negative interest rates because it was uncharted territory, and there are fears that it can disrupt the financial system. In addition, depositors can choose to hold paper currency if the trouble is overshadowed by sufficiently negative interest rates. Nonetheless, that the zero lower bound is non-binding, suggests our knowledge about the macroeconomy requires refining.

[3] Quantitative easing is the process in which central banks purchase longer-term financial assets, such as US Treasury bonds and agency-backed securities. By directly intervening in the market, central banks increase the amount of money flowing in the economy, and this larger money supply in turn lowers the cost of borrowing. In addition, purchasing longer-term financial assets raises its price and lowers its yield. Because the return on these financial assets falls, investors turn to other options such as equities, thus lowering the yield of equities as well. This reduces the cost of borrowing for businesses and stimulates the economy.

Macro-prudential policy is the new kid on the block, perhaps the next big thing. Hopes are high. Reflecting that, we have new macro-prudential agencies and policies popping up all over the world in both developed and developing economies. But that begs the question: What actually is macro-prudential policy?

Haldane does not give us a straightforward answer to what macro-prudential policy is, exactly. But one simplified way is to view macro-prudential policy as a set of measures that ensure people make prudent investments, and address systemic risks from banks that are too big to fail. One example is mandated loan-to-value (LTV) ratio. So if an asset is worth $100, and I borrow $50 to buy it, then the loan ($50) to value ($100) ratio is 50%. By setting a maximum LTV, people cannot borrow as much as before to finance their investment. In principle, this will encourage investors to be more prudent. They will have to decide carefully whether the returns are worth undertaking this investment, and whether they have the ability to bear the risks in the first place. In other words, it discourages bad risk-taking.

Macro-prudential policy is lauded by economists because unlike monetary policy, it is a *granular* tool. This means that macro-prudential policy can target specific sectors of the economy. Examples come from Stanley Fischer, former Governor of the Bank of Israel (and current Vice Chairperson of the Fed), and Choongsoo Kim, former Governor of the Bank of Korea, who shared their experiences with macro-prudential policy in their respective countries. Housing markets were overheating in Israel and Korea. One way to cool the market would be to raise interest rates, but this would impact other sectors as well. Instead, the Bank of Israel and Korea opted to use macro-prudential policy, and raised the LTV ratio for housing mortgages. This will leave other sectors unaffected – at least from the direct impact of the policy. Their attempt at this new tool was rewarded by a fair amount of success.

While macro-prudential policy is a promising tool, Haldane warned that there are also concerns. For example, its granular nature means that macro-prudential policy, like fiscal policy can target specific segments of the population. In other words, macro-prudential policy will benefit some groups and disadvantage others. For example, imposing an LTV on the housing market creates additional barriers for real estate investors, but not other investors. Hence, some economists, such as Haldane, suggested that macro-prudential policy is best left in the domain of democratically elected politicians, rather than in the hands of politically independent central banks, lest it undermines their political independence.

Stanley Fischer argues otherwise. He points out that even now, central banks employ tools that have re-distributional effect. Flexible inflation targeting, for instance, gives central banks the choice between inflation and growth – a choice that “too has distributional effects, including on unemployment.” As of now, macro-prudential policy has been largely under the jurisdiction of central banks, though some have taken precautions against compromising political independence. The

Bank of England, for example, has a Monetary Policy Committee that continues to oversee monetary policy, and a Financial Policy Committee that takes charge of macro-prudential policy. Fischer adds that "government representatives are present as observers" at the Financial Policy Committee meetings.

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Our short discussion of monetary and macro-prudential policy demonstrates the complexity of macroeconomics. The book does not stop there; it continues to examine challenges in fiscal policy, in light of escalating government debt, as well as other policies such as financial regulation, exchange rate arrangements and capital account management. The various authors, being experts in their respective fields, successfully provided detailed insights about the post-crisis economic situation.

Unfortunately, the richness of the book is highly technical. For the general reader, digesting the ideas in *What Have We Learned* can be a daunting task. The editors could improve the book by providing a chapter that summarizes key takeaways in simple terms.

As it stands, the discourse in *What Have We Learned* is dominated by experts from the US Republic of Korea and Israel's experiences with macro-prudential policy, *What Have We Learned* would have been a more balanced and wholesome read if it had incorporated, to a greater extent, experiences outside the US and EU. For example, after the 1997 Asian Financial Crisis, several central banks, including the Hong Kong Monetary Authority, Bank of Korea and Monetary Authority of Singapore, introduced LTVs, and continue to experiment with macro-prudential policies during the 2008 financial crisis. Surely, the result of their decades-long experimentation can inform discourse about macroeconomic policy.

So, back to the questions, how can we avoid another financial crisis, and how should we respond if it became inevitable? The truth is, the book raises even more questions in trying to answer these. It indicates that our understanding of macroeconomics remains imperfect. Oliver Blanchard, Giovanni Dell'Ariccia and Paolo Mauro expressed this most elegantly:

To go back to the issue raised at the start of the discussion, despite significant research progress and policy experimentation in the last two years, the contours of future