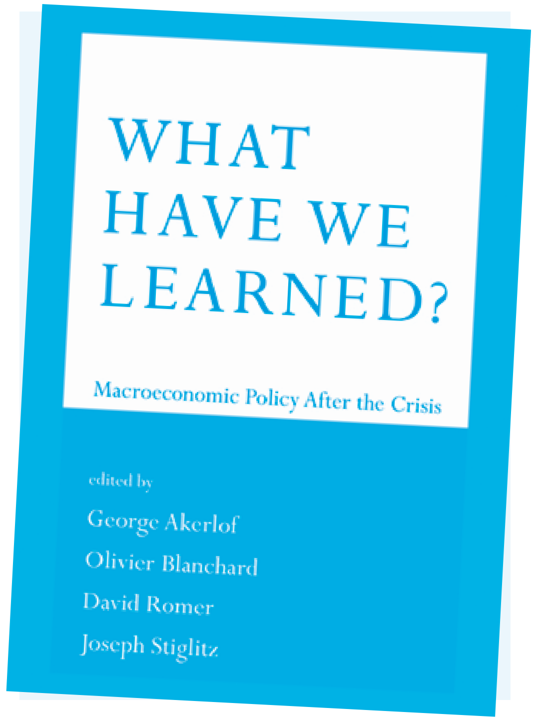
George Akerlof – Olivier Blanchard – David Romer – Joseph Stiglitz

What Have We Learned? Macroeconomic Policy After the Crisis



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HOW TO LURE THE CAT OFF THE TREE AND HOW TO MAKE SURE THAT HE DOES NOT CLIMB BACK

The financial crisis has had a profound effect on Hungary,[1] so it is also very interesting to see from the Hungarian aspect how the practicing economic policy makers and some academic lecturers of other countries view the steps already taken and yet to be taken for overcoming the crisis.

In the spring of 2013 the International Monetary Fund (IMF) has organized its second conference entitled "Rethinking Macroeconomic Policy" since the breakout of the financial crisis.[2] The goal of the conference was to review the experience gained from the crisis as well as the general economic policy conclusions to be drawn for the future with the involvement of renowned lecturers. The summary of studies published after the conference presents the ideas of the 31 participants who were recruited from the ranks of Nobel laureates such as Akerlof and Stiglitz, renowned academics, senior economists of international organisations, ministers of finance and former central bank governors or the ones who are currently in office, or have taken office since the conference.

With regard to the fact that the presentations cover very diverse topics and reflect heterogeneous views I will only highlight some of the topics and ideas, using my liberty as a reviewer.

How did the cat get on the tree?

Akerlof is right when he compares the situation that evolved in the wake of the financial crisis to the one in which a cat climbs up a high tree out of fear but he is not willing or able to come down.[3] But anyway, why were the players of the economy, the decision-makers and the economists taken by surprise by the crisis and its protraction? Or as it was brought up by *Queen Elizabeth II* when she visited the Department of Economics at the London School of Economics: "Why didn't anyone see it coming?"[4]

In the studies several factors that may have caused this "blindness" were mentioned. In the period from the mid-1980s to the crisis the developed countries, especially the USA, saw moderate economic fluctuations and price stability, which they thought to be long-lasting.[5] This period could be regarded as basically successful by the central bank decision-makers who mainly ran the system of inflation targeting, as the system using one tool (short-term interest rate) for one goal (inflation) was seemingly functioning well. In this period, those ideas came to the foreground in mainstream economic thinking which were intended for finetuning the economic policy (literature on business cycles, optimal interest rate policy, etc.).

In the meantime the financial system became more and more extensive and complex, however, financial innovations whose usefulness could hardly be judged were made. In this respect the opinion expressed by *Paul Volcker*, who was the Chair of FED in the 1980s, is very apt, who said that ATM was the only useful financial innovation in the past decades.[6] But it is not only the financial innovations that are problematic but also, as is explained by *Turner,* even traditional credits are inclined to be treated by the financial system as risk-free investments as long as the creditor duly performs. *Stiglitz* thinks that it was also a mistaken view that diversification eliminates risk. On the contrary: risk allocation may make the entire system unstable. In summary, this means that instead of moderating risks these factors have made the financial system an enormous systemic risk element. However, the financial system and lending were not included in the range of tools and models of analysis used by the decision-makers of economic policy, which means that the inherent risks and potential consequences were not taken into account or were not assessed either.

It is Stiglitz who calls attention to the deepest roots of the crisis, as he is convinced that the markets are not stable, not efficient and are not capable of self-correction.[7] In Stiglitz's view, the mainstream of economic thinking was convinced of the very opposite of this, which is why the examination of the stability of the economy was not in the focus of the analyses. The models used for economic policy were based on a basically stable framework, or one that always returned to the equilibrium through their efficient internal mechanisms, so they were deemed to failure not only in the forecasting of the crisis but they were not adequate for handling the crisis either.

How to get the cat off the tree?

As the economic policy decision-makers were taken by surprise by the subprime mortgage crisis, they were not prepared for the management of the crisis either. In the escalating crisis it soon became clear that the conventional tools for reviving the economy are insufficient and partially cannot be deployed: the base rates decreased to almost zero in a few months, while fiscal policy, especially in Europe, had no real space to manoeuvre due to the high levels of debts.

Unique, so to say improvised measures were taken to mitigate the crisis and recover the economy. With regard to the narrow fiscal leeway and the fact that the root causes of the crisis were financial in their nature, the role of monetary authorities was appreciated. In the areas that were considered to be the most problematic, a high number of new, targeted central bank tools, as well as micro- and macroprudential rules were applied for intervention. The authors of the collection of studies, who are central bank officials, such as *Yellen* from FED, *King* from the Bank of England, *Kim* from the central bank of South Korea and *Fisher* from the Bank of Israel regard the measures (taken by them) both efficient and successful.

Despite the bigger monetary leeway, the authors commenting on fiscal policy (Eberly, Borg, Perotti, Roubini) emphasize that the Keynesian economic policy aimed at reviving the economy and generating demand, which was slightly despised before the crisis, is very efficient. Several authors explain that in crisis-ridden, low-demand periods, especially if even monetary policy reaches the lower zero interest rate cap and the economy is trapped in a liquidity crisis, fiscal policy can revive the economy with a high level of efficiency, preventing that the lack in demand results in a final disintegration of productive capacities.

It is *Blanchard* who calls the readers' attention to yet another important factor in the management of the crisis, which is confidence. In this respect, authentic communication is very important, which helps avoid the realization of the worse scenario from among several possible equilibrium outcomes. Blanchard brings up the example of high government debts: the market may deem high debts unsustainable, so the debt becomes actually unfinancable as a self-fulfilling prophecy due to the high yield expectations. On the other hand, the market may deem the debt sustainable, so it may be willing to finance it with low interest rates, which ultimately helps preserve the debtor's solvency. In this respect, one of the most successful examples for communication is the statement made by ECB President *Draghi* "whatever it costs"[8], as a result of which the government bond yields of the peripheral countries of the euro area, which had previously shown excessive values, returned to a sustainable level.

What should we do to avoid the cat climbing up the tree again?

Although in Akerlof's opinion, the management of the crisis was a success, or even more successful than that of the previous financial crises, so, if you like, we managed to lure the cat off the tree, perhaps the most interesting ideas of the collection of studies are about how well we have drawn the conclusions from the crisis and what we have done to avoid its recurrence.

In this respect, there are more disturbing opinions than optimistic views in the collection of studies. The most positive opinion is formed by Akerlof, who emphasizes that as compared to the average performances following the previous financial crises, the economy of the USA is recovering more speedily, which he attributes to the successful crisis management.

As regards the future, several authors voice their opinions that it would make sense to develop an adequate fiscal space, which may be applicable for an anticyclical economic policy in the case of a potential new crisis. However, the studies rather show helplessness as to how and when the currently swollen debt portfolios could be reduced to such an extent that would already allow sufficient scope of action for fiscal policy, without breaking the fragile economic recovery.

It is no surprise that the most alarming opinions were those of *Romer* and Stiglitz, who made their comments at the panel discussion of the conference: they think that much remains to be done for avoiding further crises. On the one hand, Romer argued that the applied crisis management tools only provide superficial solutions. The base rate is not a universal remedy, and the special central bank programs, the macro- and microprudential tools are only suitable for putting out fires.[9] To replace ad hoc, short term solutions, he urges the development of such solutions which increase the resistance of the economies. Thus, besides encouraging further analyses, he brings up the need to significantly increase bank capital requirements, to return to the simpler financial systems of the 1960s and 1970s, to levy the Pigovian tax, which would compensate for the externalities of the financial system, to strengthen the automatic fiscal stabilizers, as well as to spread the costs of bank rescues in the euro area. Related to this last proposal, it is worth mentioning that having learnt their lesson from the early years of the crisis, by establishing the banking union, the European decision-makers took great strides in ensuring that difficulties in the financial system of a country do not necessarily involve the infeasibility of the budget of the country in question.

On the other hand, Stiglitz underlines that just the past 30 years have seen some 100 crises in the world, in the light of which it is an especially fake illusion to think that we have overcome crises once and for all. In his opinion, we still underestimate the inclination of markets to instability, and we look at the fluctuations of the economy as exogenous shocks, although they evolve endogenously, arising from the characteristic features of the economic system. Furthermore, it enhances the risks of greater crises that intertwining between the players of the financial system increased rather than decreased. Thus, the financial difficulties that some of the players face may increasingly spread throughout the rest of the financial system. As the consequence of this diagnosis, Stiglitz argues for the substantial reconsideration of economic thinking. He thinks that the models used in economic policy should be restructured, breaking with the representative players approach, explicit attention should be paid to heterogeneity and the impact mechanisms of the financial system.

By way of conclusion

Hungarian readers may ask the question: what lessons we can learn from the ideas collected in this volume, what relevance they hold for us. On the one hand, Hungary as an economy closely integrated in the international economy is strongly interested in the North Atlantic economies' finding and consistently following their way out of the most severe crisis of the past decades. On the other hand, the ideas explained in this collection of studies may be inspiring for the economic policy discussions held in Hungary too, which may result in the further strengthening of the Hungarian economy.

So, I recommend this volume to those who are interested in economic policy and also to those, who have so far not been interested. The collection of studies discusses issues which will definitely keep both practical and theoretical economists busy for several years to come. However, this discussion will not only be an intellectual mindfight for these professionals but it will definitely impact our lives and our living standards in the future.

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Notes

[1] In Hungary GDP decreased by 6.6 percent in 2009 which was the 7th greatest decline in the member states of the European Union. Source: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&plugin=1&language=en&pcode=tec00115

[2] The materials of the conference are available at http://www.imf.org/external/np/seminars/eng/2013/macro2/. The collection of studies contains the edited versions of the lectures. In the spring of 2015 the IMF held a third conference with the same title but a different subtitle ("Progress or Confusion"), the presentations of which are available at http://www.imf.org/external/np/seminars/eng/2015/macro3/.

[3] Akerlof, G. (2014): The Cat in the Tree and Further Observations: Rethinking Macroeconomic Policy II. In: Akerlof et al, 2014 (ed.) What Have We Learned? Macroeconomic Policy after the Crisis, pp. 317–320

[4] Quoted by Turner, A. (2014): Leverage, Financial Stability, and Deflation. In Akerlof et al, 2014 (ed.) What Have We Learned? Macroeconomic Policy after the Crisis, pp. 165–175

[5] King, M. (2014): Monetary Policy during the Crisis: From the Depths to the Heights. In Akerlof et al, 2014 (ed.) What Have We Learned? Macroeconomic Policy after the Crisis, pp. 45–53

[6] Quoted by Blanchard, O. (2014) Rethinking Macroeconomic Policy. In: Akerlof et al, 2014 (ed.) What Have We Learned? Macroeconomic Policy after the Crisis, pp. 321–326

[7] Stiglitz, J. E. (2014) The Lessons of the North Alantic Crisis for Economic Theory and Policy. In: Akerlof et al, 2014 (ed.) What Have We Learned? Macroeconomic Policy after the Crisis, pp. 335–347

[8] https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html

[9] Romer, D. (2014) Preventing the Next Catastrophe: Where Do We Stand? In Akerlof et al, 2014 (ed.) What Have We Learned? Macroeconomic Policy after the Crisis, pp. 327–333