PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

# Rethinking macro stabilization Evolution or Revolution?

December 2017

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# The three main lessons we draw from this crisis

- Two previous crises changed both macroeconomics and macroeconomic policy.
  The Great Depression, and the Stagflation of the 1970s

- What will the Great Financial crisis do?

- What we argue:
  - Lessons go beyond just adding a financial sector
  - Need to question some cherished beliefs. Among them:
    - Is the economy self stabilizing?
  - In a very different environment. Low interest rates

- Then, draw implications for monetary, fiscal, financial policies

# Lessons from past crises

- The Great Depression:
  - The economy can implode
  - Aggregate demand is central.
  - Need for aggressive policies, especially fiscal

  - Apparent success, from 1940 to the late 1960s

- The stagflation of the 1970s:
  - The Keynesian approach has failed/need for a new approach
  - Think of fluctuations as ``business cycles''
  - With predictable policy rules, economy will be stable
  - Focus on monetary policy, inflation targeting, interest rate rule

  - Apparent success, from the mid 1980s to the mid 2000s

# The three main lessons we draw from this crisis

- The centrality of the financial system
- The nature of fluctuations
- An environment of low rates ("secular stagnation"), which interacts with the first two.

One should add, but we leave it aside:

- The increasing salience of inequality (interacting with low growth)

# 1. The centrality of finance

- Ignored, but not for lack of warnings: Hyman Minsky et al. The lost decade (two?) in Japan. LTCM, the high tech stock crash, sudden stops in EMs.

- In mainstream, focus on financial channels rather than crises (Bernanke). At the border, work on liquidity (Holmstrom Tirole), leverage (Geanakoplos)

- A large amount of very good work since the crisis. But still incomplete understanding. Two examples:

- During the crash.
  - Solvency, or liquidity? In what combination
  - Two views. (How to interpret Tarp repayment?)

- After the crash.
  - Problems on the creditor/bank side, or on the debtor side?
  - Proportions? Who needs the most help, when? (where to put the debt?)

# 2. The nature of fluctuations

- Earlier convergence on a vision/set of tools:
    - Shocks and propagation mechanisms
    - Largely linear.  Self stabilizing.
    - Movements of actual output around exogenous potential
    - DSGEs, VARs right tools.

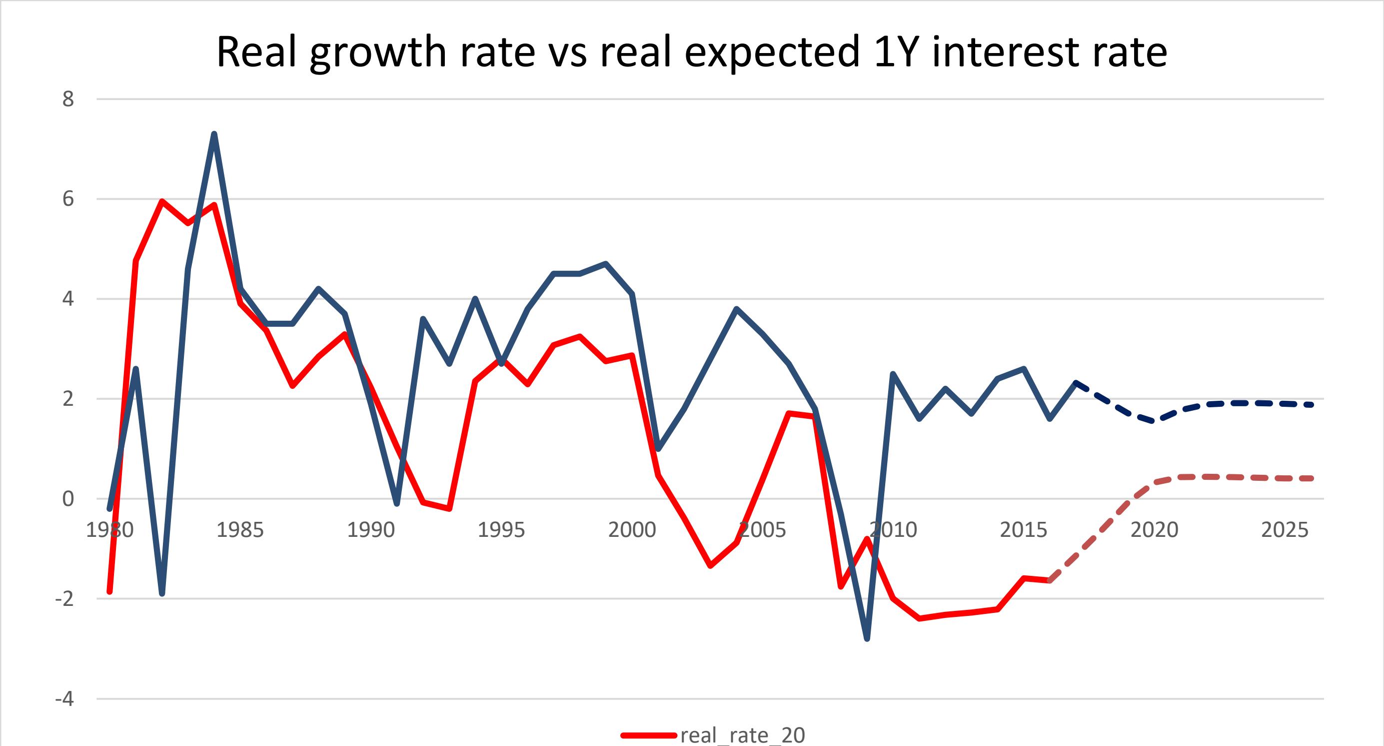
- Financial crises do not fit the mold:
    - Slow buildup, then crash.  Earthquake/plate tectonics
    - Non linearities:  Runs (bank runs, sudden stops).
    - Extrapolative expectations:  Central to build ups.
    - Long tails.  Output far below trend.  Hysteresis?

- Beyond financial crisis:
    - Non linearities more generally (ZLB, bankruptcy…)
    - Economy not obviously self stabilizing

- Challenges for general frame of research/policy framework

# 3. Low interest rates/Secular stagnation

Low real safe rates.  Decline started long before financial crisis. Expected to be lower than growth rates.




Sources: FRB, Haver, CBO Forecasts

# Low interest rates, continued

- Low MPK and all rates in general, or large safety premium?
  - A long list of candidates for both.
    - S/I versus safety/liquidity premium
    - Will the low rates last? Markets believe so:
    - Yields on 10-year indexed bonds: 0.4% US, -1.1% Germany, -0.4% Japan.
- Strong interactions with the two earlier lessons:
  - Limits on monetary policy. Higher probability of ZLB
  - More space for fiscal policy. Especially if $r<g$
  - Likely more risk taking, and higher financial risks

# Turning to policies

# Implications for monetary policy? Three challenges

- Main/urgent one: Space to react to future adverse shocks?
  - Average decrease in policy rate in last 6 recessions: 5% (range from 2% to 10%). Current long run forecast rate: 2.75%
  - QE helps, but how much more space is left? Spreads are small already

- A higher steady state inflation rate?
- Are there smarter ways?

  - Nominal income targeting. In 6% range?
  - Price level targeting. Good on the undershoot side, bad on overshoot
  - Forward guidance, shift to price level targeting when at the ZLB?
  - Increase inflation expectations only if and when needed?
  - Evidence on expectations, Japan, not overwhelming.

# Monetary policy. 2

- Extending the mandate to include financial stability?
    - ``Leaning versus cleaning” ?
    - Interest rate a very poor tool to deal with risk
        - May decrease risk taking at the margin
        - Increases risk within the margin (existing debtors)
    - Timing nearly impossible to get right.
        - On both economic and political economy grounds
        - (Greenspan irrational exuberance at Dow 6300)

Bottom line: Leave it to macro pru/financial regulation (on Svensson’s side rather than Borio’s)

# Monetary policy. 3

- What size balance sheet to aim for in normal times?
    - Need to look at consolidated Treasury/CB position
    - Debt in the hands of the public (excluding CB).
    - Then two issues:
        - Optimal composition
        - Division of labor between Treasury and CB
        - Provision of very short maturity assets (Greenwood/Hansen/Stein). Interest bearing money
        - Decrease of spreads at longer maturity. Alleviate ZLB?
        - Be in the markets, in case.
    - Most/all (?) of it can/should be done by Treasury debt management (Differences Fed/ECB)

# Fiscal policy. 1

- Because of  constraints on monetary policy, more important to use it.
- Because of low neutral real interest rates, more fiscal room to use it.
- Fiscal policy as stabilization tool
  - Why no progress on automatic stabilizers?
  - Why no progress on discretionary policy?
- Debt policy when r<g?
  - Cannot be sure it will be forever, but r can be locked in: 0.9% for 30-year.   Very likely to be less than average g.
  - A sign of dynamic inefficiency/excess capital?  Probably not.
  - More a large safety premium.

# Fiscal policy. 2

Implications for policy:

- Government can probably run deficit/issue debt/never repay, without D/Y explosion. But should it?

- If safety premium reflects distortions, or insufficient provision of safe assets, maybe better to supply it, even if as a result $r>g$

- If output gap, a very strong case.

- If no output gap? Relax about debt consolidation? How much?

- A case for public investment, for 3 reasons:

    - Has been too low for a long time (esp during consolidation)
    - $r<g$.
    - Hysteresis (DeLong Summers)

# Financial policies. 1

Practice (by necessity) ahead of theory. Dodd-Frank, FSB, Basel agreements:

- Higher capital ratios. Evidence on cost of capital, lending, suggest they should be be even higher.
- Different capital measures, capital ratios: Tier 1, leverage ratios, etc.
- Requirements increasing with size, systemic importance (?)
- Liquidity ratios.
- Stress tests.

- Not much on shadow banking.

- Macro pru. Much discussion, little implementation. Downpayments, cyclical capital surcharges.

# Financial policies

- List of challenges is long.   Will mention just two:

- Belt, or belt and many suspenders?
    - Capital ratios (what level?) and stress tests enough?
        - Recent US stress tests passed with flying colors
        - Evidence of robustness of system or weakness of tests?

- High and constant, or lower and variable?  Fin reg/macro pru?
    - Capital ratios, down payments on mortgages?
    - Getting the timing right (like monetary policy)
    - Political economy implications (worse than monetary policy)

# Conclusions 1.

- Think of events of last ten years
  - Runs on largest financial institutions
  - Interest rates in liquidity trap for nearly 10 years
  - Large remaining unemployment gaps in Europe
  - Output far below the pre-crisis trend in AEs

- Business as usual?  No (but reasons to be worried)

  - Economies do not self stabilize
  - They may implode, there may be hysteresis
  - Need strong pro-active and reactive policies
  - A role for all three:  Money, fiscal, and financial

# Conclusions 2. Evolution versus Revolution?

- The case for Evolution
  - Models can be extended. Much wisdom to be kept
  - Non linearities mostly in ``dark corners''
  - Financial crises will remain rare events
  - Limited secular stagnation: Neutral rates likely to be positive
  - Can be handled with the right combination of the 3 policies.
  - Increase room of maneuver for m policy, use fiscal policy more, use financial regulation more.

- The case for Revolution
  - Not amenable to VAR, DSGEs. Need new approaches
  - Financial crises very likely again. Poorly understood
  - Economies unstable. Non linearities essential
  - Secular stagnation here to stay. Japan
  - Much higher inflation? Higher public debt? Smaller financial system.

- Time will tell…