Rethinking macro stabilization
Back to the future

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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,
      -1.0% 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 side rather than Borio’s)
Monetary policy.

• 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

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

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

• Belt, or belt and many suspenders?
  • Capital ratios 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

  • 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
  • In many ways, ``Back to the future’’ and the Keynesian revolution
Conclusions 2. A post scriptum

• If truth be fully told:
  • Slight (but productive) tensions between the two authors.

• Evolution or Revolution?

• The case for Revolution
  • Financial crises very likely again. Poorly understood
  • Economies unstable. Non linearities essential
  • Secular stagnation here to stay.
  • Not amenable to VAR, DSGEs. Need new approaches

• 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
  • Can be handled with the right combination of the 3 policies.

But common agreement on the need for change.