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Changes in Macroeconomic Policy: Evolution versus Revolution*

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Olivier Blanchard – Lawrence H. Summers:
Evolution or revolution? – Rethinking Macroeconomic Policy After the Great Recession
MIT Press, 2019, p. 392
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Hungarian translation:
Fejlődés vagy forradalom? – A makrogazdasági politika újragondolása a Nagy Recessziót követően
Pallas Athéné Könyvkiadó, Budapest, 2019, p. 428
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In 2011, at the initiative of *Olivier Blanchard*, Chief Economist at the IMF at the time, a series of conferences commenced with the title "Rethinking Macroeconomic Policy", with events organised every two years. The latest conference was hosted by the *Peterson Institute for International Economics* in Washington, and the conference papers were published by *MIT Press* in 2019 in the form of book: Evolution or Revolution? – Rethinking Macroeconomic Policy after the Great Recession. Fortunately, in September 2019 the Hungarian version was also published, under the editorship of *Pallas Athéné Könyvkiadó.*

The book's two editors are a guarantee for relevant and interesting analyses, since – in addition to their scientific activity – they also have considerable economic policy experience, and following the 2007-2008 crisis both of them participated actively in the rethinking of macroeconomic policy: Olivier Blanchard was a Professor at MIT and then Chief Economist at the IMF; he is currently a Senior Fellow at the Peterson Institute. *Lawrence H. Summers* is a Professor at Harvard University, former Treasury Secretary in President Clinton's administration and former director of the National Economic Council for President Obama, and once Chief Economist at the World Bank.

* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

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In their introductory paper, the editors highlight three main lessons. First, the crisis made it obvious that one of the key reasons behind macroeconomic fluctuations is the behaviour of the financial system, and thus the further development of macroeconomics and the elaboration of more efficient macroeconomic policies calls for a more in-depth understanding thereof. Second, it is necessary to qualify the pre-crisis view according to which business cycles are caused by exogenous shocks, to which the economy reacts linearly. Financial shocks usually develop endogenously and the reaction of the economy to large shocks is non-linear. Finally, the permanently low interest rate environment is one of the key determinants of current economic policies. Blanchard and Summers emphasise that – in contrast to the pre-crisis period, when monetary policy enjoyed priority – we now need all three branches of macroeconomic policy, i.e. monetary, fiscal and financial regulation policy. The book examines five topics: *monetary policy, fiscal policy, financial policy, economic inequality and political economy, and international economy issues.* Each topic is accompanied by a comprehensive study, followed by short addenda and reactions. Due to space constraints, this review only discusses the five main papers.

The first paper in the book is by Ben Bernanke (Senior Fellow at the Brookings Institution, former Chair of the Federal Reserve and Professor at Princeton University) on monetary policy. In line with the introductory paper, Bernanke also regards the low interest rate environment as the greatest challenge for monetary policy, since this significantly narrows the room for monetary policy manoeuvre, as it is not possible to reduce nominal interest rates significantly below zero. At the same time, Bernanke considers forward guidance and quantitative easing as feasible alternatives to interest rate policy. In the paper, he provides an in-depth analysis of the experiences accumulated in applying the aforementioned instruments. He is of the opinion that negative interest rates and control of the yield curve cannot be regarded as generally applicable instruments. He rejects raising the inflation target as a potential method to reduce the real interest rate. On the other hand, as an alternative to this, he finds it worthwhile for central banks to consider price level targeting instead of inflation targeting, in a low interest rate environment.

The second part of the paper deals with central bank independence. Traditionally, the main argument for central bank independence is that due to the time inconsistency of monetary policy, there is a great temptation for economic decision-makers to generate surprise inflation based on short-term considerations; however, elected governments are less inclined to resist this temptation compared to independent central bankers. In the present low inflation environment, the validity of this argument has been questioned by many, noting that in a low inflation and growth environment, central banks should support fiscal stimulus packages

rather than autonomous monetary policy. On the other hand, the question of central bank independence goes beyond the problem of time inconsistency, since monetary policymaking can be highly technical and is often time-sensitive. Furthermore, effective monetary policy requires consistent, coherent and timely communication with financial markets. Hence, it should be controlled by a body that is able to provide prompt and accurate answers to changing economic and financial conditions.

But what is the situation with independence when the economy faces significant deflationary risks and monetary policy is only able to resolve the problem in cooperation with fiscal policy? Bernanke believes that central bank independence is a practical principle rather than an ideological or philosophical thesis: it only makes sense if (on average) it leads to better monetary policy outcomes. Thus, the applicability of central bank independence depends on the economic circumstances. Accordingly, central bank independence does not preclude cooperation between monetary policy decision-makers and fiscal authorities, if two conditions are met: first, the objectives of the cooperation must be consistent with the central bank's mandate and it is an important condition that they cannot be achieved without cooperation; second, the central bank must continuously evaluate whether the first condition is satisfied, retaining the power to stop coordinating at any point if it is not.

The paper by *Alan J. Auerbach* (University of California, Berkeley) deals with fiscal policy. One of the most important lessons from the post-crisis period is that since – in the low interest rate environment – monetary policy is constrained by the zero lower bound of the nominal interest rate, there is also need for fiscal policy. However, the practice of fiscal policy remains in the crossfire of disputes. Before the crisis, most policy-makers were sceptical about the effectiveness of fiscal policy, since they believed that expenditure and tax multipliers were low. Since then, however, numerous empirical papers have demonstrated that fiscal multipliers were higher than thought to be before the crisis, particularly during times of recession, and when the zero lower bound of the nominal interest rate is binding. Accordingly, in certain situations, fiscal policy is not only necessary, but also expedient.

The question of fiscal rules is important in terms of the effectiveness of fiscal policy. Fiscal rules are justified by the objective of avoiding time inconsistency, by the long-term effects of distribution among the generations and by fiscal sustainability. At the same time, it was confirmed that overly rigid fiscal rules are inefficient, and in certain cases the application of discretionary fiscal policy is unavoidable. Instead of overly rigid rules, the author urges the establishment of fiscal councils. In a low interest rate environment, it is favourable from the aspect of applying fiscal policy that the cost of capital and debt servicing burden

of government programmes is lower. However, it should be noted that the debt-to-GDP ratio is not a perfect indicator of fiscal sustainability, and that additional criteria, such as implicit liabilities, should also be taken into consideration.

The authors of the comprehensive paper on financial policy are *David Aikman, Andrew G. Haldane, Marc Hinterschweiger* and *Sujit Kapadia* (Bank of England). First, they review the reform of financial regulation implemented on the basis of Basel III. It should be noted that the new regulatory system does not only use the microprudential approach; i.e. it does not only focus on the stability of individual financial institutions, but also considers systemic risks, and thus also has macroprudential elements. In the analysis, they emphasise the significance of new components such as liquidity-based standards, the countercyclical capital buffer – as the first dynamic regulatory component – and management of the shadow banking system.

The authors point out that the new regulatory system has multiple elements and is multipolar, due to the fact that the risks of the financial system stem from a variety of sources, which can only be addressed by different instruments. Furthermore, the actors of the financial system are keen to circumvent certain regulatory tools, but when there is a complex network of regulatory instruments these attempts are less likely to succeed. The paper empirically demonstrates that the regulatory elements have a tangible effect on the banking sector's balance sheet and describes to what extent the regulatory instruments may reduce the probability of financial crises and to what extent they would mitigate the effects of a potential crisis. At the same time, the authors also consider the potential macroeconomic costs of the regulatory measures.

At the end of the paper, the authors review what kind of additional studies they deem necessary in areas such as defining the optimal level of regulatory capital, the development of financial stability models, the macroprudential policy framework and the financial stability implications of FinTech developments.

The relationship between economic growth and income/wealth inequalities is discussed in the presentation by *Jason Furman* (Harvard Kennedy School). According to the author, although intensive analyses are underway on the relationship between economic growth and inequalities, in terms of economic policy the key issue is the effect of potential public policies on growth and inequality rather than whether inequality reduces or increases economic growth. Thereafter, those examples are examined which have positive effects on both factors, such as, for example, education. Subsequently, policies, such as the tax policy are analysed, which do not necessarily have simultaneous positive effects both on growth and inequality.

The international aspects of macroeconomic policies are discussed in the paper by *Gita Gopinath*, Chief Economist at the International Monetary Fund. Her main findings are as follows: 1) The gains from exchange rate flexibility are smaller than you think; 2) The "trilemma" lives on (it is not possible to simultaneously implement a fixed exchange rate, autonomous monetary policy and free flow of capital); 3) The exchange rate of the US dollar drives global trade prices and volumes; 4) Gross capital flows matter as much as net flows, and global banks have internationalised US monetary policy; 5) Emerging markets' shift away from foreign currency debt towards local currency debt reduces their exposure to global risk factors; 6) The low interest rate environment can lead to misallocation of resources and lower productivity; 7) The relationship among global imbalances, reserve accumulation and currency manipulation is not well identified; 8) Uniform border taxes are not neutral; 9) Trade is not the main driver of earnings inequality, but at the same time, policy has failed to address its redistributive consequences; 10) Global coordination of financial regulation is essential.

On the whole, it can be stated that in the past decade the direction of economic policy has changed and become much more complex. According to the authors, the question as to whether this can be regarded as evolution or revolution has not yet been decided. The response to this largely depends on the macroeconomic developments in the years to come.