Joint Vienna Institute

MACROECONOMICS AFTER THE CRISIS

JVI ALUMNI MEETING, SARAJEVO

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October 14, 2015

- Overview
- Monetary Policy
- Fiscal Policy
- Macroprudential Policy
- Capital Flows
- Conclusions

Pre-Crisis Thinking—
A Simplified Stylized View

Monetary Policy

- One target
- One instrument
- Divine coincidence

Fiscal Policy

- Secondary role, limited by practical constraints

Capital Flows

- Complete liberalization generally desirable

Financial Regulation

- Limited interaction with macroeconomic framework

For an excellent discussion, see Blanchard et al. (2010, 2013).

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Monetary Policy: Rethinking after the 2008 Crisis?

The 2008 crisis has provoked renewed debate about the ***objectives*** and ***instruments*** of monetary policy because

- Some consider that loose monetary policy was partly responsible for the bubble…
  - …or at least that central banks should have leaned harder against the asset bubbles building up in the 1990s/2000s
- In the aftermath of the crisis, traditional instruments (policy rates) proved ineffective (zero lower bound)…
  - …many central banks moved to unorthodox instruments (QE in US, Japan, and Eurozone; heavy forex intervention in Switzerland)

Monetary Policy: New Objectives?

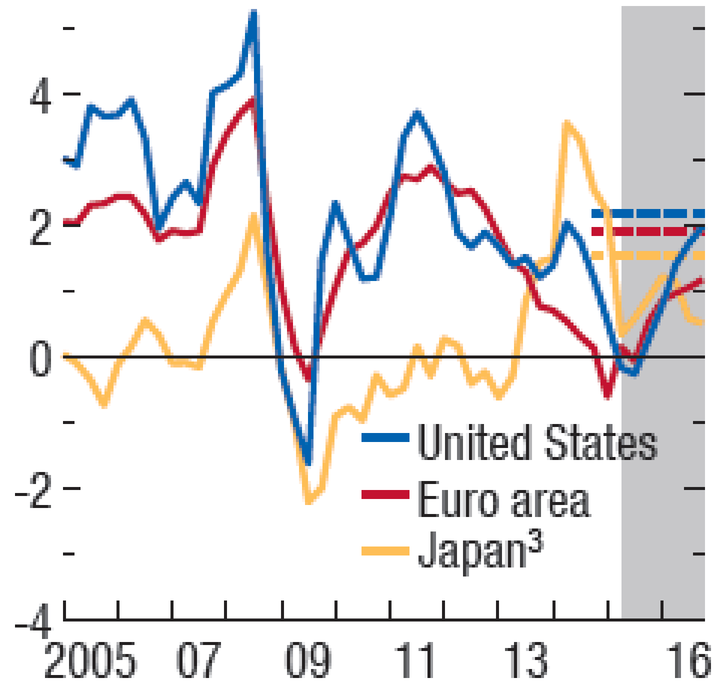
- Should central banks also have other objectives:
  - ➢ Financial stability (for the sake of future output stability)…
  - ➢ …Or the exchange rate?
- If financial stability is added to the mandates, central banks would have to lean against emerging asset bubbles…
  - ➢ …Tightening monetary policy even if not warranted by prevailing price/output developments.
- Can emerging asset bubbles be clearly identified?
- How much tightening (and possible current output losses) should/would the authorities be prepared to undertake to prick the bubble?

In the absence of other instruments, monetary policy tasks would be very difficult. New role for cyclical regulatory tools or macroprudential tools.

Monetary Policy—A Higher Inflation Target in Normal Times?

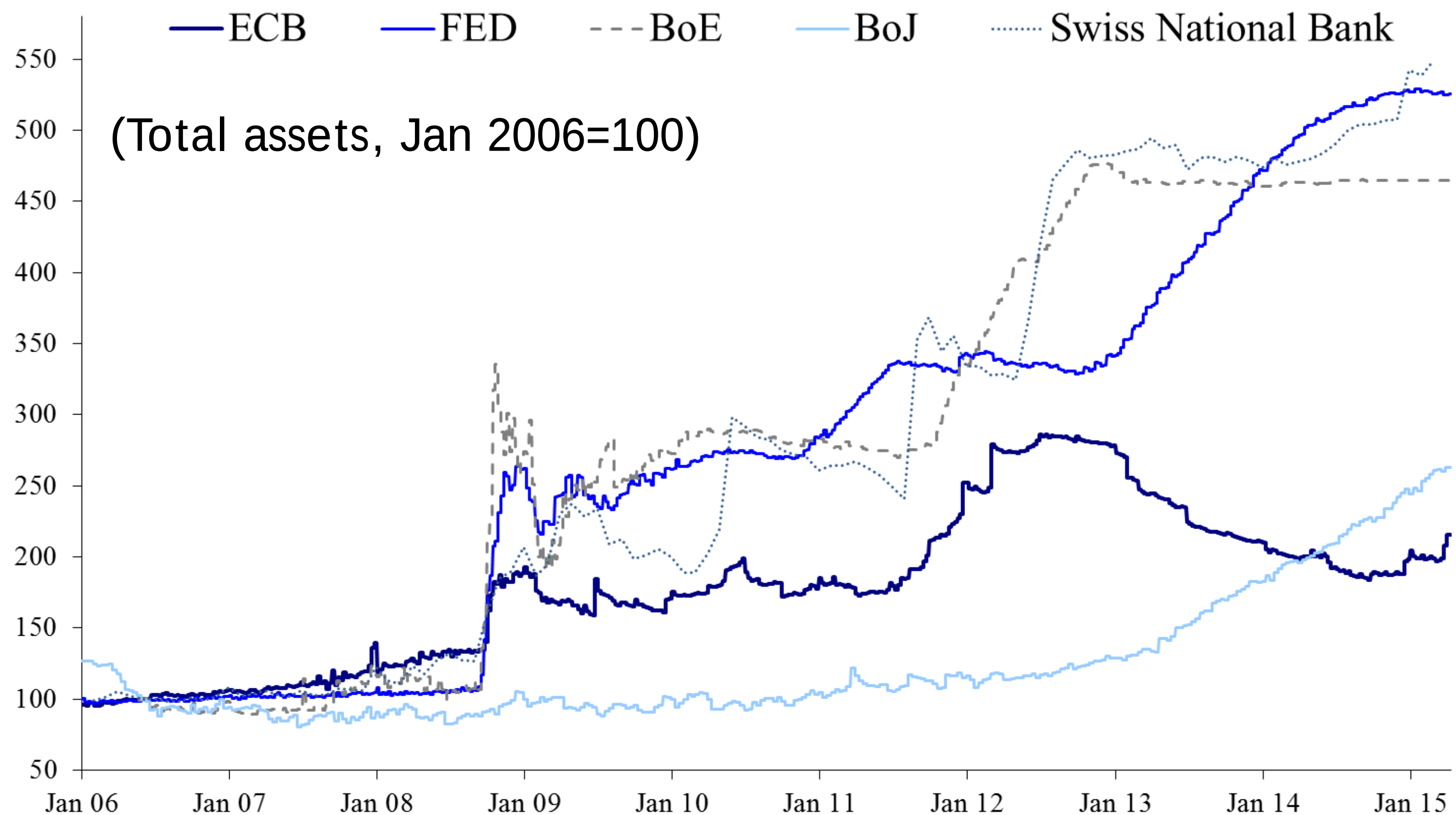
- Increase the room for manoeuver for monetary policy
- Considerations:
  - (Net) costs of higher inflation
  - Ability to anchor inflation expectations
  - Impact on output volatility
- Some propose nominal GDP target

Headline Inflation 1/



1/ Dashed lines are the six-to-ten-year inflation expectations.
Source: IMF, WEO, April 2015, Blanchard et al. (2010).

Central Banks' Balance Sheets Expanded Sharply—Return to Pre-Crisis Levels and Policies in the Medium-Term?



Source: www.ecb.europa.eu, from presentation Frank Moss, "The ECB's non-standard policy measures—domestic and global impact, Joint Vienna Institute, Vienna, May 22, 2015 at http://www.jvi.org/special-events/2015/consequences-of-the-eurosystems-non-standard-measures-for-the-western-balkans.html

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Much Discussion About

- Fiscal Policy as Stabilization Tool
- Multiple equilibria and the appropriate level of debt
- Interaction with central bank policies and fiscal dominance
- Fiscal Adjustment and “Exit Strategy”

Fiscal Policy as Stabilization Tool—Developing Views

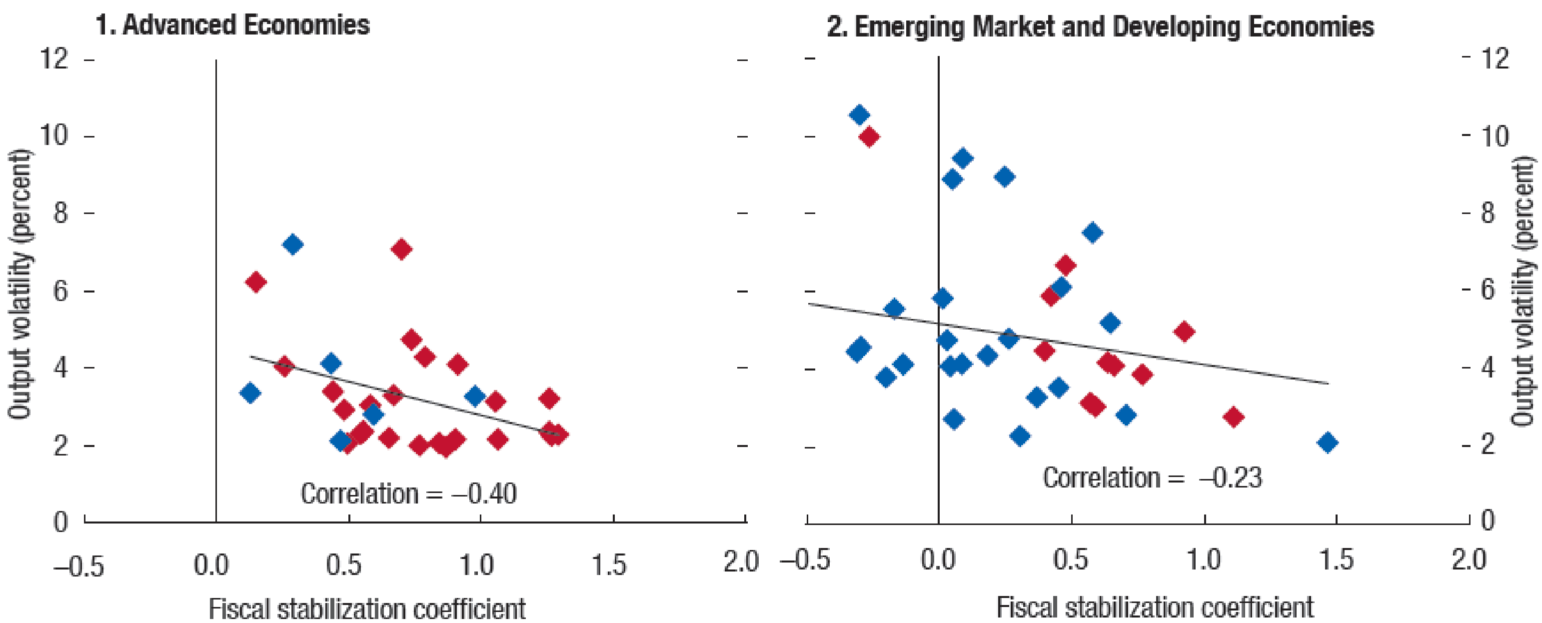
Keynes	• Fiscal Policy as key macroeconomic policy tool
1960s/70s	• Monetary and fiscal policy broadly equal role
1980s to pre-crisis	• Discussion of Ricardian equivalence, political limitation • Limited attractiveness as stabilization tool • Focus on debt sustainability and fiscal rules

Recent Analyses Suggest Fiscal Stabilization Policies are Beneficial

- **Comprehensive study:** broad sample (85 countries, 1980-2013)
- **Fiscal policy is, on average, stabilizing:**
  - ➢ More in advanced economies, more in bad times, more at low frequency
- **Automatic stabilizers (AS) are key:**
  - ➢ Contribute about 2/3 in advanced economies and 1/3 in developing economies
  - ➢ Main determinants of AS: government size and social transfers
- **Dividends of fiscal stabilization are significant:**
  - ➢ Higher and less volatile growth
- **Internalize the role of automatic stabilizers:**
  - ➢ Let AS play freely → avoid procyclicality

Source: IMF, Fiscal Monitor, 2015.

Greater Fiscal Stabilization is Associated with Lower Output Volatility



Source: IMF, Fiscal Monitor, 2015, p. 33.

Debt and Multiple Equilibria

- Worried by higher risk of default, investors may demand higher risk premia
  - Pushing up interest rates and thus increasing the risk of default
- Most critical when debt maturities are short and rollover needs large
- Particularly worrisome since these self-fulfilling pressures arise erratically in financial markets
- Perception of default risk seems to be more unstable for countries in currency unions
- Multiple equilibria can exist even at relatively low levels of debt

The Role of Central Banks

- In principle, central banks can eliminate bad equilibria:
  - By providing—or by just committing to provide—liquidity to the government
  - E.g., ECB's Outright Monetary Transaction (OMT) program
- But in a monetary union, a country has no sole control about central bank policy
- More generally, concerns about fiscal dominance might arise
- Large fiscal adjustment needs may create pressures on central banks to limit borrowing costs or inflate away debt

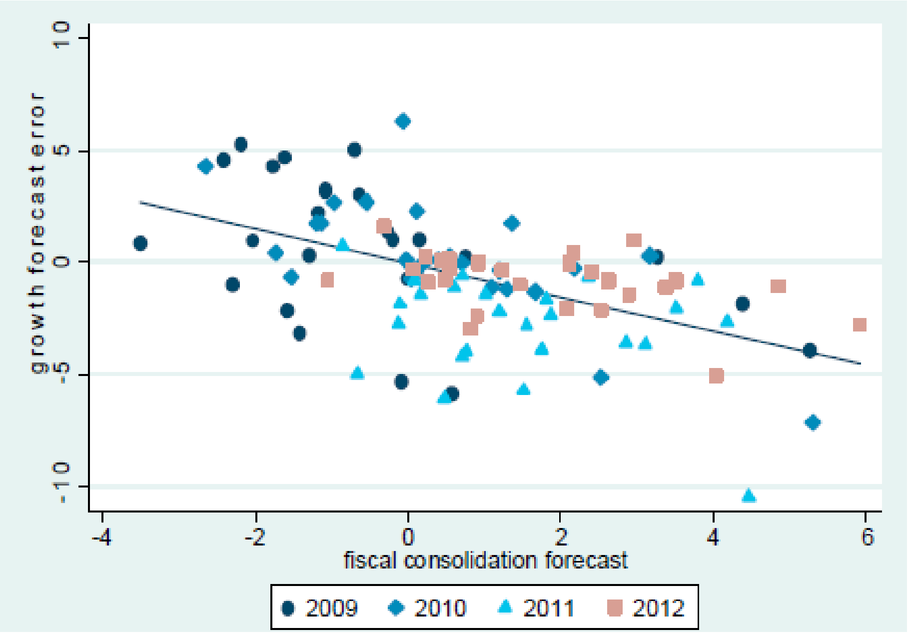
Pace of Adjustment: Frontloaded Adjustment versus Gradual?

Possible/Alleged Advantages of Frontloading	Possible Disadvantages of Frontloading

• Maximize debt reduction
• Minimize corporate and household uncertainties
• Boost market confidence
• Associated with higher long-term growth
	• Excessive frontloading can hurt growth, efforts may be self-defeating
	• Effects may be particularly large, even nonlinear, during deep recessions
	    • Multipliers higher in times of recession
	    • Hysteresis effects

Forecasters Underestimated Fiscal Multipliers

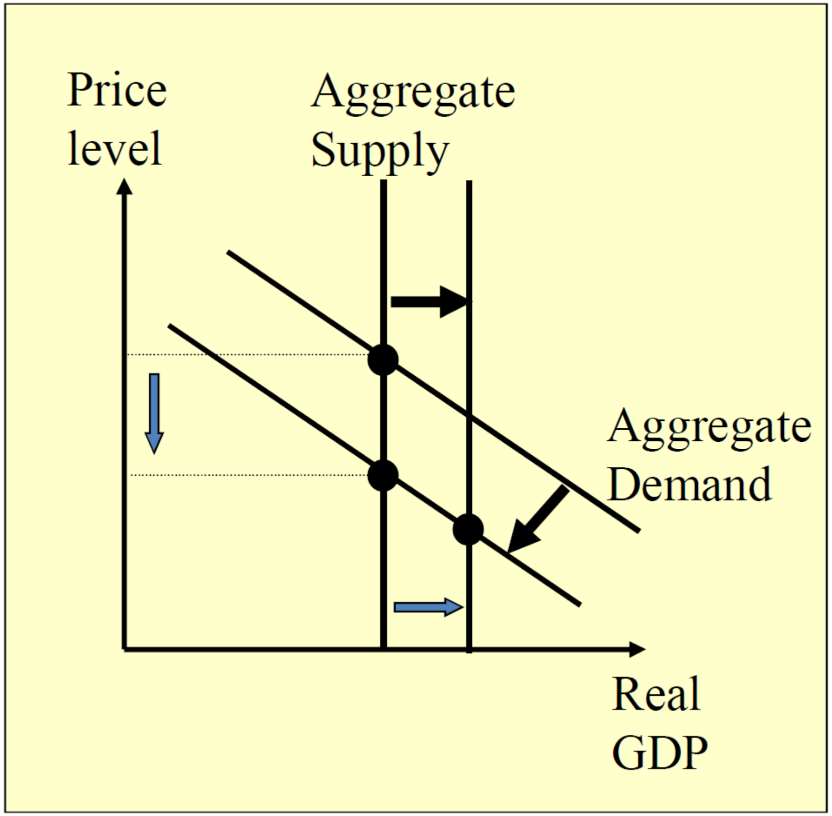
- Blanchard and Leigh (2013):
  - In principle, growth forecast error should not be systematically related to inputs used to produce the forecast
  - In practice: negative correlation between growth forecast error and expected consolidation



The Composition of Fiscal Adjustment

- Before the crisis, expenditure-based consolidations were seen as more durable than revenue ones, in particular in countries with high-revenue to GDP ratios
  - Distortionary impact of taxes (e.g., income taxes) could weigh on growth by reducing labor supply, investment, profitability
  - Expenditure cuts, incl. on wages and welfare, may lower labor costs and promote investment, employment, net exports, and growth
  - Large consolidations were often to a large extent expenditure based
- Revenue-based consolidations could be durable, when initial revenue-to-GDP ratio is low
- Less clear-cut after the crisis, but need to protect the most vulnerable (and equity considerations)

Role of Accompanying Structural Reforms



- Stabilization helps contain demand
- Structural reform expands supply
- Stabilization is faster, but structural reform allows stabilization at a higher level of real income

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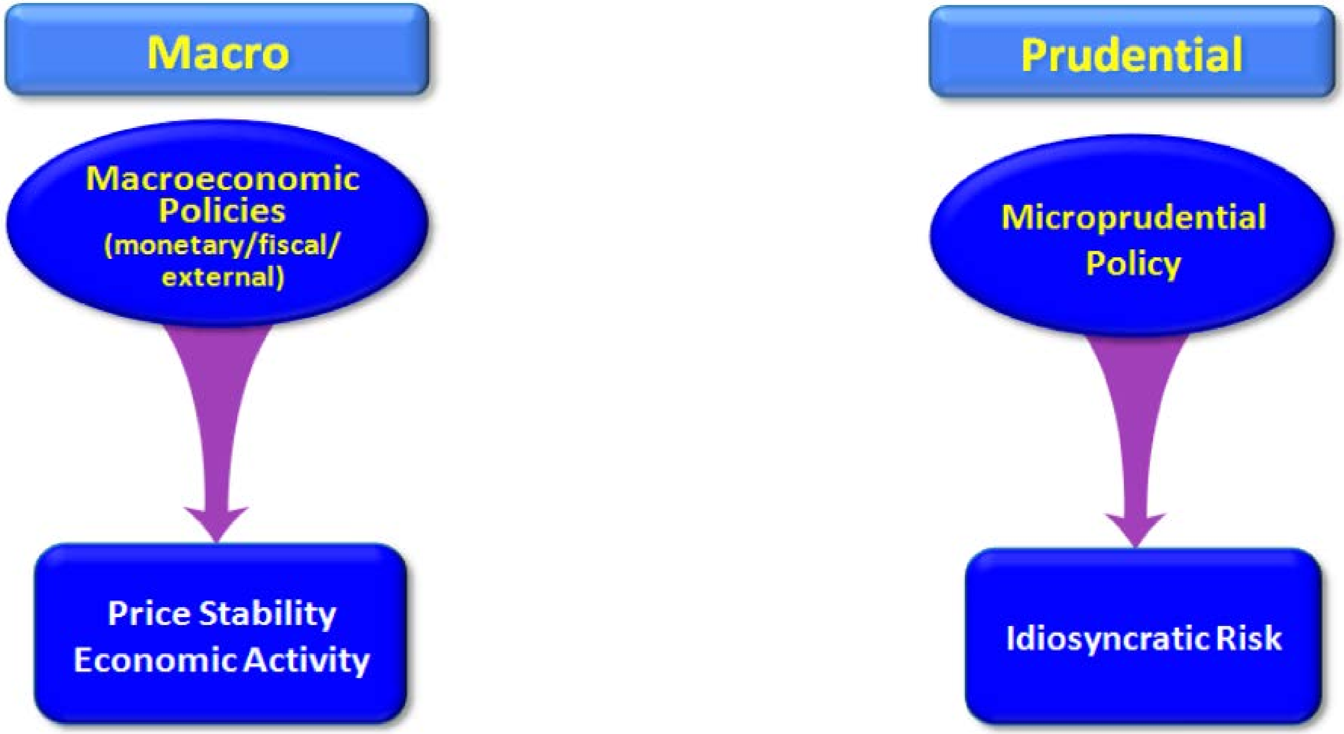
Regulation and Supervision

- Banks are special
  - Bank credit is not easily substituted
  - Maturity transformation (deposit insurance)
- Resulting distortions main reason for regulation

- Prior to the crisis:
  - Limited attention paid to financial system from a macroeconomic point of view
  - Focus on individual institutions, ignoring interactions and macroeconomic implications
  - Little use of regulatory ratios in a countercyclical way, especially in advanced economies

Pre-Crisis "Consensus" on Macro Policies and Regulation

How we saw the world before the financial crisis



Crisis has Changed the Consensus

Macroprudential Frameworks: Necessary Today

- Countries have developed/are developing macroprudential frameworks/macroprudential authorities:
  - Central bank
  - Separate authorities

- A number of instruments are used as macroprudential measures:
  - Caps on loan-to-value and debt-income ratios
  - Countercyclical capital buffers
  - Dynamic provisioning: "Dynamically adjusted financial regulation" (P. Tucker)

Relationship with Monetary Policy

- New paradigm—both monetary policy and macroprudential policy are used in countercyclical management:
  - Monetary policy for price stability
  - Macroprudential measures for financial stability

- Potential “side effects” of one policy on the objectives of the other:
  - Can reduce or enhance the effects of the other?
  - Need for coordination

Macroprudential Policy and Monetary Policy can Enhance Each Other

- But financial stability concerns are hard to capture in practice:
  - ➢ Again, when to employ macroprudential policy?
- Limited knowledge on the impact of macroprudential policy
- Macroprudential policy might not work perfectly:
  - ➢ Not well targeted and does not offset all financial shocks and distortions
- Institutional constraints:
  - ➢ What tools to use and how to coordinate them? How to best coordinate with microprudential policy?

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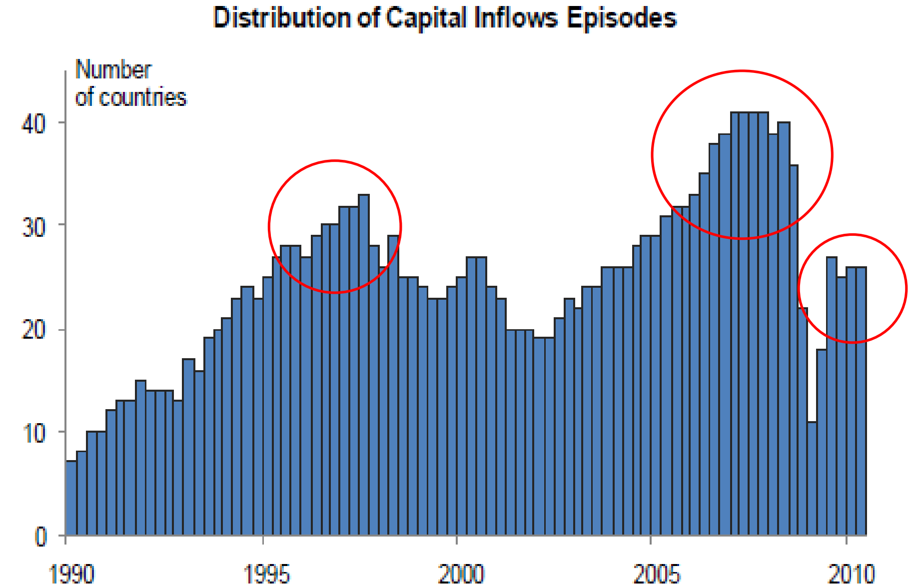
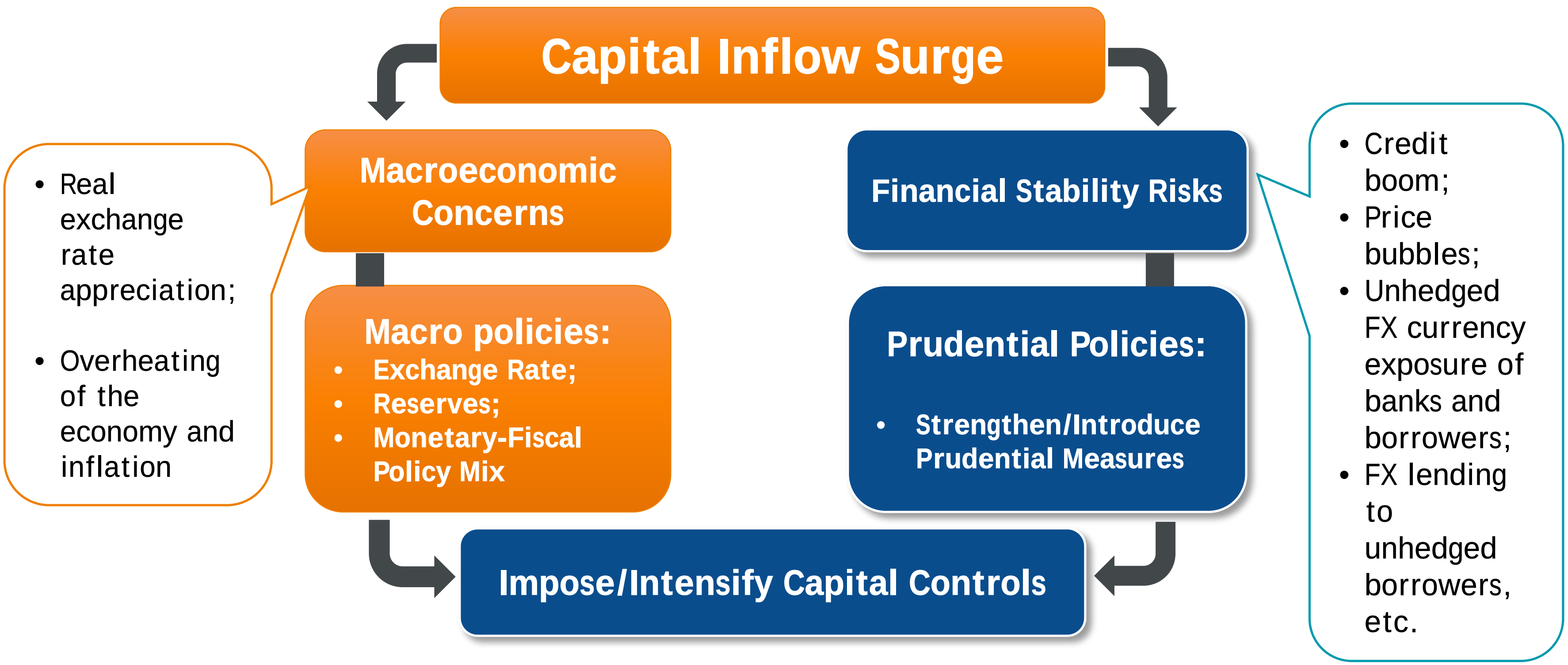
Three Waves of Strong Capital Inflows to Emerging Markets

- **Surge:** a quarter in which capital inflows 1 st.dev. above long-run trend and of large magnitude (higher than 1.5% of annual GDP)
- **Episode:** a prolonged surge (a series of surges)
- **Wave of inflows** (large number of countries episodes occurring at the same time)
  - 3 waves identified



Source: IMF Policy Paper, 2011: 48 EMEs analyzed

IMF Institutional View on Capital Flows: Example Policy Options to Manage Capital Inflows



Source: The Liberalization and Management of Capital Flows: An Institutional View, IMF, Nov. 2012; Ostry et al., 2010, Capital Inflows: The Role of Controls, IMF Staff Position Note, 10/04.

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Much of the Pre-Crisis Consensus still Holds, But also some Emerging Post-Crisis Issues

Monetary Policy

- Costly zero lower bound
- Policy rate no longer sufficient, because markets are segmented

Fiscal Policy

- Importance of fiscal space
- Risk of multiple equilibria
- Debt anchor
- Importance of stabilization tool

Capital Flows

- Controls justified if macroeconomic and macroprudential measures are exhausted

Financial Regulation

- Closer link between financial regulation and macroeocnomic developments
- Role of macroprudential policies

Some Considerations for Bosnia and Herzegovina

- Strong growth prior to the global financial crisis
- Lackluster growth following the crisis with several starts and stops, but recent signs of a recovery
- Far-reaching structural reforms are needed to increase potential growth and continue the process of convergence by promoting private sector development and reducing resilience to shocks:
  - Improve the business environment to attract investment
  - Enhance functioning of goods and labor market to reduce unemployment and increase productivity
  - Reform and develop financial sector to reduce vulnerabilities and facilitate access to finance
  - Improve infrastructure to improve productivity and attractiveness for FDI

Some Considerations for Bosnia and Herzegovina

- Fiscal policy
  - ➢ Balance fiscal consolidation: ensuring debt sustainability, creating fiscal space, and supporting the recovery
  - ➢ Support consolidation through fiscal reforms
    - ✓ Strengthen revenue collection and administration
    - ✓ Reduce size of spending, while protection the most vulnerable through better targeting social assistance
    - ✓ Improve composition and quality of spending
    - ✓ Strengthen controls over lower levels of governments and state-owned enterprises
- Monetary Policy
  - ➢ Currency board arrangement provides stability
- Financial sector
  - ➢ Many proposals in recent Financial Stability Assessment
  - ➢ Address high-level of non-performing loans (e.g., streamline collateral procedures, facilitate corporate debt restructuring and resolution)
  - ➢ Strengthen supervisory and macroprudential policies

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