What have we learned from the crises?
The debate on macroeconomic and financial polices

AFS-JICA Seminar Series
Academy of Financial Studies, Colombo
August 28, 2013

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Pre-crises: Life was simple

- Fiscal policy should eschew discretionary policy; use automatic stabilizers and focus on long-term fiscal sustainability.
  - Discretionary policy doesn’t work or can’t be timed properly. (Multiplier less than 1, even zero or negative in small open LDCs.)
- Monetary policy by independent CB should target inflation using short-term interest rates.
  - Low and stable inflation will ensure stable long-term economic growth
- Financial systems and capital flows should be liberalized.
- Exchange rates should be flexible.
- Transparency, Disclosure, Governance and Institutions are important
  - Markets will check bad behavior.
  - Supervision of individual institutions will ensure financial stability.
  - Crisis occur in countries with weak governance and institutions.
### Crises: Common Causes

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<tr>
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<th>Global Financial Crisis</th>
<th>Euro-zone Crisis</th>
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<tr>
<td>Credit extension beyond repayment capacity</td>
<td>Sub-prime mortgages, real estate bubble.</td>
<td>Greece Government (and other euro periphery).</td>
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<tr>
<td>(Public and private) failure to recognize mounting vulnerability</td>
<td>Not seen as bubble. AAA rating for securitized products. Sub-prime market is small.</td>
<td>Weak enforcement of SGP. No sovereign risk premium. Greece is a small country.</td>
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<td>Not act decisively to prevent crisis</td>
<td>Refuse to save Lehman Bros.</td>
<td>EU constitution ‘prevents’ Greek bail out.</td>
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<td>Magnifying factors</td>
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<td>- Macro-financial linkages</td>
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### Crises: Different responses

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<th>GFC (including Europe)</th>
<th>Eurozone crisis</th>
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<tbody>
<tr>
<td>Financial sector policies</td>
<td>Massive government intervention (liquidity support, guarantee, recapitalization)</td>
<td>Fiscal constraints limit support in crisis countries. Forbearance and private recapitalization.</td>
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<td>Monetary policies</td>
<td>Unconventional policies in the face of zero bound on interest rates. Replace broken private intervention. Increase CB balance sheet. Act on expectations.</td>
<td>Policies to support sovereign debt markets and to provide liquidity to crisis countries.</td>
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<td>Fiscal policies</td>
<td>Large coordinated discretionary stimulus (G20).</td>
<td>Fiscal consolidation to restore fiscal sustainability.</td>
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<td>International monetary policies</td>
<td>Massive cross-border official liquidity support (FED and IMF).</td>
<td>Constraints on 'bail-out'. Private sector 'bail-in'.</td>
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Differences in outcomes

Acute phase of GFC ends relatively quickly, while Euro-zone crisis drags on.

3 months Libor-OIS spread

Libor-OIS spread is a measure of the credit risk premium charged in interbank lending.

Fiscal Stimulus, % of Po GDP

United States  Euro area

Growth in Euro-area stalls

Bank balance sheet repair not seen in Europe

Source: IMF (various publications) and author’s calculations
Lessons

• Cost of financial crisis is huge and impact is prolonged.
• Advanced economies are not immune to crisis.

  – What to do to avoid a financial crisis:
    • Strengthen financial sector regulation and supervision.
    • Focus more on financial stability as an explicit macroeconomic policy goal, because microprudential policies are not enough.
    • Have a better mechanism to limit spillovers and contagion.
    • Sovereign debt sustainability is a cornerstone of financial stability.
    → How do you design such a system? How do you get from A to B?

  – What to do when a crisis hits:
    • Provide liquidity, support demand and restore confidence (if you have the capacity).
    → How do you deal with constraints and trade offs when the capacity is not available? How much consideration needed to guard against moral hazard?

Lessons and Debate: Monetary Policy

• Is inflation targeting still valid?
  – Stable prices do not guarantee financial stability (though low inflation still an important policy goal).
  – Less agreement on how to incorporate financial stability concerns in monetary policy. → Focus on macroprudential tools.

• Unconventional policies – do they work, or simply create larger imbalances?
  – Zero lower bound on interest requires (untested) unconventional policies.
  – Quasi-fiscal nature of policies damage CB credibility?
  – Transmission mechanism is not clear. (Is it essentially an exchange rate policy and/or forcing global monetary easing on other countries?)
  – Can you exit smoothly?

• Multiple goals in normal times?
  – Should monetary policy explicitly target output/unemployment?
  – Should monetary policy target asset prices?
Lessons and Debate: Fiscal Policy

- **Effectiveness of Fiscal Policy**
  - Active fiscal policy is effective and useful in periods of deep and prolonged recession (multiplier around 2).
  - High debt levels reduce the feasibility of deploying fiscal policy, so maintaining fiscal space is important.
    → But how much space, when do we use it, how do we maintain it, and (if we are not there) how do we get there?

- **Austerity in Fiscal Crisis**
  - Opposing views as to whether austerity in crisis is necessary or harmful. (Probably both. What is the trade-off?)
  - A compromise position is to argue for a combination of short-run stimulus and credible medium-term consolidation strategy.
    → But can you implement this in practice?
  - How to implement austerity if there is no alternative. (Distributional effects, political acceptance.)
Debate: Financial Sector and Macroprudential Policies

- How much capital is enough?
  - How much is enough to reduce systemic risk to ‘acceptable’ levels.
  - Should we focus more on simple leverage?

- Does higher capital requirement and transition to higher capital force deleveraging and limits credit supply and thus damage growth?
  - Are forced higher charges incompatible with adequate supply of financial intermediation?

- Are restrictions on activity necessary, and to what extent?
  - Separation, ring-fencing regulated entities. Regulating shadow banking.

- How much scope for government backstop should be retained.
  - Moral hazard and dynamic inconsistency.

- Which macroprudential policies are effective/desirable?
  - Price based tools (capital and liquidity rules, etc.) or more targeted and quantitative rules (limits on LTV, credit to sectors, etc.)
  - Distributional consequence of measures.

Lessons and Debate: Capital Flows Management

- Realization that countries with ‘good’ policies can experience crisis.
  - Even countries without clear policy weaknesses and vulnerabilities may experience crisis
  - Capital inflows from push factors may increase vulnerabilities

- Are capital controls useful? – Yes, but…
  - Which measures are effective, and under what conditions?
  - Should capital flows management measures be used as a last resort measure, or be a regular feature of external policies?
Debate: Exchange Rate Policies

• Risks in monetary union is much larger than was supposed.
  – Can monetary union be maintained with tougher rules for individual countries without a banking union and fiscal union?

• Should central banks target exchange rates?
  – As an element of inflation target, or on its own merit?
  – Effectiveness of capital flows management measures determine feasibility.

Lessons and Debate: Crisis management

• The old trade-off: adjustment vs. voluntary financing. (IMF as an honest broker.)

• The new trade-off: adjustment vs. voluntary financing vs. collective debt reduction vs. debt repudiation.
  – How to construct an internationally applicable mechanism for orderly debt resolution.
Implications for emerging markets and developing countries

• Macroeconomic policy debate and theory for AE will become more relevant for EM and DC.

• Uncertainty as to what good policies are.

• But bad policies are still bad policies.

Thank you