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Economics: Pre-Crisis Consensus vs. Post-Crisis Confusion

In what is seen as one of the most unprecedented move in an economics classroom, students of Harvard University staged a walk-out from EC10 (in Nov-11). EC10 is an introductory course in economics taught at Harvard University and is perhaps one of the famous economics class in the world. The class is currently taken by Greg Mankiw, a noted economist also famous for his economics textbooks which is widely read all over the world.

The students upstaged a walkout as they felt disconnected from the real world. The introductory class focuses on the virtues of free markets and competition but that is not what the students are getting to see all around the world. There is huge government and central bank intervention all around the world with firms (both financial and real sector) getting bailed out. There is little doubt that the real world is very different from the classroom teaching. As economics seeks to explain the world around us, students are bound to feel disoriented and dissuaded to study economics.

One seeing this walkout (which Mankiw nicely phrased as Occupying Harvard after the Occupy Wall Street Movement), economics professors poured their advice to make classroom economics a more connected place amidst students. This event serves a constant reminder of how economics has abstracted itself from the real world.

In this paper we look at some of the key questions which really need a rethink from the economics profession. Before the crisis, the profession had arrived on a broad consensus on many economic policies and functioning (called in this paper as pre-crisis consensus). This consensus has been shaken in this crisis and in some areas it has posed some serious questions on the consensus (called in this paper as post-crisis confusion). The paper reviews both the pre-crisis consensus in key economic areas and the post-crisis confusion in each of the economics areas. If the profession does not wake up to these questions, the students are likely to keep ringing the alarm bells once a while.

I. Monetary Policy and Central Banks

- **Pre-crisis consensus:** The pre-crisis monetary policy framework and life of central banks was easy and defined in four words – Just manage inflation expectations. For managing inflation expectations, the highly preferred framework was inflation targeting where central banks kept an inflation target and used interest rates to bring actual inflation in line with the target. It was assumed that as long as inflation is managed the rest of the economy will also be stable. Price Stability was seen as a necessary condition for all the economic ills in an economy and in some cases (like financial stability) had become a sufficient condition as well.

  It was ironical that though central banks conducted monetary policy, there was hardly any role of money in the formulation of monetary policy. Most central banks barring RBI and ECB have stopped tracking monetary indicators like money supply, credit etc. The monetary policy models also did not include any role for these monetary indicators focusing just on interest rates to dampen aggregate demand pressures.

- **Post-crisis confusion:** If central bankers had acquired a near demigod status before the crisis, the crisis has shown they are mere humans (and devils in some cases). The chaos can be divided on following lines:

- Price Stability alone is not enough for economic prosperity. It may still be necessary but is just one of the many necessaries in the list. Before the crisis there was low inflation and it was felt that all is fine in the economy. But in the background, financial instabilities were building as households, corporates and banks were increasing their debt levels assuming the good times to continue.

- Central banks of advanced economies have been blamed for creating the crisis as they kept rates low for a prolonged period of time. There is a huge debate on this issue which has been discussed in our previous report (Economists Debate: What were the causes of the 2007 crisis, Mar-11).

- The role of central banks in the current crisis will be an agenda for research for many decades. Central banks not just cut policy rates but also expanded their balance sheets substantially as policy rates touched zero. Federal Reserve in particular has been very innovative with range of measures even when policy rates touched zero. These measures in a way silenced critiques who said central banks are powerless when rates touch zero. However, the role of these measures in stimulating the economy comes under scanner as banks are just sitting on additional reserves and are hardly lending. The corporates are also not borrowing despite rates being record-low as either they are deleveraging or not investing in a highly uncertain environment. The broad summary is when policy rates touch zero they are usually extreme times and recovery is not going to be as fast as it is assumed. Earlier the experiences were limited to just Japan and now with most developed economies engulfed in the problem, it is time to take a re-look at research on liquidity trap economics.

- The crisis has posed questions on the objectives of central banks. Some feel central banks should stick to their mandate of price stability and lender of last resort. Others feel financial stability should be added to central banks objectives as latter monitor developments in financial markets closely. The monetary transmission is dependent on the state of financial markets and as a result central banks follow the latter closely. Most central banks issue financial stability reports as well and hence should be guardians of the same as well.

- The next issue is if central banks are to take up the role of financial stability as well, what new tools and instruments should be given to them? Interest rates are seen as a blunt tool to address financial stability and central banks need additional tools like risk weightages, leverage ratios etc to address financial instability. Earlier the focus was on microprudential policy and has now shifted to macroprudential policy. Economies have responded to this challenge in different ways which we have discussed in our previous report (Macroprudential Policy and Central Banking, Nov-10).

- Central banks are seen as institutions which make their policies independent of the government. Infact, independence of central banks is seen as one of the most important properties of modern central banking. In this crisis, people have questioned this independence as central banks have intervened and provided support to large number of financial entities. Central banks have responded to the criticism that this was done not to save the financial firms but the real economy as stable financial system is key to real sector. If these firms were allowed to fail it would have led to meltdown of the whole financial system inflicting further crisis in the real economy. Then there have been issues with respect to central banks aggressively buying bonds of government leading to monetization of public debt. Traditional monetary economists feel central banks have undone all the lessons and hardwork of last two decades.

Overall, there is much to do and understand in central banking and monetary policy. A shift in on single objective central bank to multiple objective central bank is going to be a major challenge. RBI Governor Dr. D. Subbarao recently called RBI a full service central bank as it manages so many functions together- inflation manager, public debt manager, bank regulator, external stability manager etc. It will be interesting to see the direction central banks take going forward.

II. Fiscal Policy

- **Pre-crisis consensus:** The pre-crisis consensus was that fiscal policy has a very limited role to play in an economy. Fiscal policy worked on an automatic stabilizer mechanism where during booms budget deficit decreases pulling back on aggregate demand. In recessions, size of the government budget deficit tends to increase when a country enters a recession, which tends to keep national income higher by maintaining aggregate demand. This effect happens automatically depending on GDP and household income, without any explicit policy action by the government and hence the name. Most recessions post World War-II were either because of higher interest rates (to lower inflation) and recession pressures eased as central banks eased policy rates. Only in Japan, we saw a prolonged recession which did not ease despite substantial easing by Bank of Japan and occasional fiscal stimulus. Japan was ignored as a one off case whose policymakers were not aggressive and as a result the crisis became a prolonged one. So as a result, the role of fiscal policy was never really understood or debated. The research on role of fiscal policy to ease crisis was very limited and ignored by top economists.

- **Post-crisis confusion:** If monetary policy and central banks got a sour reality check, fiscal policy and role of governments got a new life in this crisis. There are several issues that have come up with regards to role of fiscal policy:

  - Role of Fiscal policy in liquidity trap situation: The first tool against recession is lowering policy rates. But once central bank cut rates to zero, it cannot go any further. However, the economy still needs support as the recession is deeper. In such times, governments need to spend and invest as both private and household sector are actually lowering their debt and spending levels. This was basically the line of thought advocated by Keynes.

    However, as there were hardly any cases except Japan in 1990s of liquidity trap, role of fiscal policy in liquidity trap situation just faded from memories. Moreover, most felt central banks had enough tools even after rates touched zero and criticized Bank of Japan for being conservative in its monetary expansion.

    The 2007 crisis completely changes this view. Importance of fiscal policy was seen as monetary policy was not able to prevent the initial decline. It was only when governments cooperated to pass a global fiscal stimulus, did we see a stop in the rapid decline. Now the debate is shifting to which kind of fiscal policy tools are more useful and generate a higher multiplier –cutting taxes or higher government expenditure. Research remains divided on which of the two is more effective but more consensus is emerging that fiscal policy is useful in such times which is a big victory for Keynesian school of thought.

- Fiscal Austerity for growth: Some policymakers particularly from Europe were not really impressed with this surge of fiscal policy. The tax revenues declined sharply following recession leading to widening of the deficit. Some countries like Greece and US already had high budget deficits pre-crisis which only ballooned even more post-crisis. Other countries like Ireland saw jump in budget deficits mainly because of the crisis. The markets were particularly severe on European countries and bond yields of countries like Greece touched nearly 100% for two year bond issuances.

  In order to tackle this debt crisis, European policymakers (including UK) imposed harsh fiscal austerity measures on their troubled economies. In Europe, austerity was imposed on economies of Greece, Ireland, Italy etc as a condition for getting bailout funds. In UK, this was more of a political choice by the ruling party.

  The experiences with respect to fiscal austerity for growth have not been on expected lines. Austerity led to lower growth as government was the only sector which could spend in an otherwise shrinking economy. Minus government the growth declined even further leading to increase of the debt. There are two ways governments can lower debt levels – via higher growth or higher inflation. Higher inflation has been suggested by few economists but rejected outright by central banks as irresponsible. Fiscal austerity has led to lower growth as well leading to further rise in debt. The result has been massive social anarchy amidst populations with strikes and demonstrations. The experiences are much similar to those seen in South East Asian crisis where similar experiences were seen as fiscal austerity was imposed there as well. It is a replay of history in different settings with similar outcomes.

  Overall, though fiscal policy research has suddenly become active, there is lot of confusion about how it can be used typically in recessionary situations.

III. Financial Regulation

- **Pre-crisis consensus:** Just like monetary policy, role and scope of financial regulation has been hugely criticized. The pre-crisis consensus was of light-touch regulation where the regulator just sets up broad principles of regulation with banks and financial intermediaries deciding the rules of playing in the markets. Independent monetary policy and light touch financial regulation were seen as the major policy innovations of the pre-crisis era. Independent monetary policy delivered price stability which was seen as necessary (and sufficient by few) for financial stability. Hence, strict financial regulation was seen as a policy anachronism.

  Another major reason for this light touch regulation was policymakers strong belief in efficient markets hypothesis. It was assumed that financial markets are efficient and regulating them will only constrain the efficiency of markets.

- **Post-crisis confusion:** The approach to financial regulation has undergone a paradigm shift from light touch to heavy touch regulation. Some regulators like FSA of UK have taken a critical approach to their style of financial regulation urging to make some sweeping changes in financial regulation and economic thought towards financial regulation. New and strict forms of financial regulation have been proposed in many countries. One of the key changes in this space is increased role of central banks in financial regulation.

  Pre-crisis central banks were either taking or being advised to take limited interest in financial regulation space. Now, most of the new regulations are giving central banks more powers and responsibilities to regulate financial sector. Central Banks are moving from a single objective to multiple objective central banks (discussed above).

IV. Capital Account and Capital Controls

- **Pre-crisis consensus:** Just like it was light tough regulation for financial regulation, it was full convertibility for capital account. Most reports suggested economies should have fully open capital account with minimal restrictions. Pressures were applied on developing economies to liberalize their capital account as quickly as possible. This was rather surprising as there was plenty of economic evidence which showed that opening up capital accounts without having proper macroeconomic framework and institutions only leads to crisis. But somehow, this bit of economic history is always forgotten quickly.

- **Post-crisis confusion:** What changed significantly post this crisis is that institutions which opposed capital controls strictly started suggesting that capital controls could be used as a safeguard and macroprudential measure. The best example of this shift is IMF which says capital controls can be used for economic stability albeit these controls should be the last measure. Even though IMF suggests capital controls as last measure it is akin to a 180 degree turn on this critical issue. After this IMF change, capital controls have become more acceptable and are regularly mentioned in speeches of policymakers and research papers. Though, some economists have not really changed their minds and still believe going back to capital controls is taking many step backwards. So, just like above cases there is still a lot of confusion over role of capital controls in an economy.

V. Growth Models

- **Pre-crisis consensus:** There were varieties of growth models before the crisis.
    - UK/Iceland growth was based on its international finance centre providing financial services to the world,
    - US was a consumption oriented growth model drawing foreign capital for financing its consumption. This led to build up of large global imbalances.
    - China and East Asian economies followed export oriented models
    - European economies followed their own imbalances in the zone. Countries like Greece ran large current account deficits whereas countries like Germany ran large current account surpluses exporting to the European region. Germany supplied capital flows to countries like Greece preventing latter from making any meaningful reforms.

  Though each of these models were different, the broad theme before the crisis was to move towards more open and liberalised economy model.

- **Post-crisis confusion:**
- Each of the above growth models have come under a major question mark.
    - US consumption model was always seen as a major concern and seen as a possible source of crisis. However, most expected the crisis to come via current account route with sharp depreciation of US Dollar. However, the crisis came via the housing and financial market route which surprised most economists which took pride in the quality of US financial system.

- UK and Iceland have learnt some harsh lessons over relying too much on one sector for growth. Financial firms were much larger than size of their respective economies making bailouts practically impossible to do.
- The centre of the crisis soon shifted from US to European economies were imbalances were large. The inter-connections of government debt of peripheral economies with banking system of European core economies brought the whole Eurozone into a crisis.
- China and other South East Asian nations have realized the folly of relying on external demand for their own growth. China is attempting to make massive changes in its economic system from export driven to domestic consumption driven economy.

The crisis has opened up the growth model economics like never before. There are no easy answers on which growth models should countries follow. US needs to rely less on consumption whereas China needs to shore up its consumption levels. UK has to diversify and lower its financial sector contribution whereas China has to deepen its financial sector to channelize its domestic savings and rely less on external flows.

The consensus has moved from "One size fit model" to "Each country on its own model". These lessons are not new but are likely to apply stronger after the crisis. As the earlier crisis were mostly in developing economies, the usual criticism was lack of proper institutions and economic policies. Hence they were asked to make policies like developed economies. Now, with so many developed countries into the crisis, there is confusion over whether the lessons still apply. Infact one is now increasingly getting research on what developed countries can learn from developing economies! The idea that each country faces its unique sets of opportunities and challenges and hence needs different policies (taking international experiences as case studies) is gaining strong ground.

VI. Concluding Thoughts

The phase before the crisis put economists into a comfort zone with some commenting that most of the economic ills have been addressed. Robert Lucas, 1995 Nobel Prize winner infamously said in 2003 "central problem of depression-prevention has been solved", only to realize a near depression kind of situation five year later. Business cycle which is such been a central part of economic theory was seen as non-important with economic growth expected to continue with a few blips on the road. And whenever there was a blip, central banks would cut rates and problems would be resolved. Possibility of central banks in liquidity trap situation was kept limited for Japan with Japanese policymakers being blamed for the same. People often ask questions (including the Queen of England) on why couldn't economists see or predict the crisis. How could they see the crisis in such an environment?

The crisis of 2007 has created tremors in the economic profession. Just when most thought the field of economics has progressed greatly, it has had to go back to 1930s to pick lessons from Great Depression. Infact the profession is really lucky to have some policymakers who understood the lessons from great depression and acted vigorously to prevent a repeat of 1930s. Yes, the policy intervention has led to many questions (as asked above) but there is little doubt that without the policies, there could easily have been another depression in world economy.

In times like these students are bound to feel confused. They are being taught mainly pre-crisis consensus economics but what they see in actual is post crisis confusion. Occupying Harvard movement could have happened anywhere. That it chose the most respected economics department shows some serious thinking has to go into teaching economics principles which resembles reality.

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