"Economic Policy Challenges in the Post-Crisis Period"

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Good afternoon. It is my great pleasure to take part in the inaugural conference of the Institute for New Economic Thinking. It has brought together many thoughtful people from academia, government, finance, and business, and is asking many of the key questions that face the economics profession today.

The global financial crisis—and the Great Recession that followed—have inflicted tremendous economic and social damage across the world. Thankfully, we now appear to be on the path to recovery—though it remains sluggish and uneven, and in need of continued policy support in many advanced economies. Moreover, the costs of the crisis—lost growth, high unemployment, and sharply higher public debt—will take many years to overcome.

The crisis has also laid bare some fundamental weaknesses in the economic and financial policy framework. Our confidence in markets, institutions, and the status quo turned out to be complacency; we learnt how fallible, fragile, and interconnected we are.

Now that we have emerged from the immediate crisis response period, the time is right to take stock of the lessons of the recent experience, and what they mean for economic and financial policies in the period ahead. We at the IMF have also been contributing to this effort, as reflected in our recent publications on the lessons from the crisis for macroeconomic policy, capital controls, climate policy and other issues.

Today, I'd like to focus on three topics in particular: the need for greater coordination between monetary policy and financial regulation; the need for fiscal adjustment, and for better fiscal stabilizers; and the importance of international policy cooperation. I will also elaborate on the role that the IMF can play in supporting these efforts.

Pre-crisis consensus

Let me begin with a brief description of the pre-crisis consensus as it relates to monetary policy, fiscal policy, and financial regulation.

First, monetary policy. Low and stable inflation was considered the primary, if not exclusive, mandate of central banks. After the high-inflation experience of the 1970s, central bankers were keen to establish their reputation as being "tough on inflation". This position was given intellectual rigor by the New Keynesian model, which held that constant inflation is the optimal policy choice for keeping economic growth at the potential rate. So, keeping inflation low and stable was the best way to secure optimal economic performance.

Second, fiscal policy. In the decades preceding the crisis, fiscal policy had taken a back seat to monetary policy, for various reasons: skepticism about the effects of fiscal policy, based largely on Ricardian equivalence arguments; concerns about lags and political influences in the design and implementation of fiscal policy; and the need to stabilize and reduce typically high debt levels. In addition, automatic stabilizers were considered sufficient to allow fiscal policy to respond to changes in the economic cycle.

Third, financial regulation and supervision. Here, the focus was on the soundness of individual institutions and markets, and aimed at correcting market failures stemming from asymmetric information or limited liability. Broader macroeconomic implications of financial sector risks were largely ignored. Given the enthusiasm for financial deregulation, the use of prudential rules for cyclical purposes was generally considered an improper interference in the functioning of credit markets.

For about a quarter century, this macroeconomic framework seemed to deliver. The so-called "Great Moderation"—marked by declining output volatility and moderate inflation—lulled us into believing that we knew how to conduct macroeconomic policy. In addition, the successful responses to the 1987 stock market crash, the LTCM collapse, and the bursting of the tech bubble reinforced the view that monetary policy was also well equipped to deal with asset price busts. Thus, by the mid-2000s, it was not unreasonable to think that better macroeconomic policy could deliver, and had delivered, higher economic stability.

Admittedly, these views were more closely held in academia; policymakers tended to be more pragmatic. Nevertheless, the prevailing consensus played an important role in shaping policies and institutions. Success in moderating fluctuations may even have helped sow the seeds of this crisis. The Great Moderation led too many—including policymakers and regulators—to underestimate macroeconomic risks and, in particular, to ignore tail risks.

What we have learned from the crisis?

Then came the crisis—and in its wake, the weaknesses in the pre-crisis consensus became evident. We now know that threats to macro-financial stability may develop beneath a seemingly tranquil surface of stable prices, small output gaps, and healthy public finances.

We have also learned that financial regulation can have a major macroeconomic impact. Regulatory weaknesses, including in the perimeter of regulation and supervision, allowed significant risks to build up, and enabled the bursting of the U.S. housing bubble to turn into a major global crisis. And, once the crisis started, rules aimed at guaranteeing the soundness of individual institutions worked against the stability of the system. For instance, mark-to-market rules, coupled with constant regulatory capital ratios, forced financial institutions into fire sales and deleveraging.

So, while many tenets of the pre-crisis consensus—notably low inflation and fiscal discipline—remain valid, others may need to be reconsidered. The crisis has also demonstrated that macroeconomic policy must have many targets. Fortunately, the crisis has also reminded us that we have many instruments to reach these targets.

The crisis has also highlighted the critical role of international policy cooperation. During the crisis, unprecedented cooperation allowed us to avert another Great Depression. In the post-crisis period, such cooperation is needed even more to create the policy framework to support strong and stable economic growth.

Greater coordination between monetary policy and financial regulation

What are the lessons for monetary policy?

Even before the crisis, there was a lively debate whether the interest rate rule, implicit or explicit, should be extended to deal with asset prices. The crisis has added a number of targets to the list, from leverage to measures of systemic risk.

In my view, this seems like the wrong way of approaching the problem. The policy rate is a poor tool to deal with excess leverage, risk taking, or apparent deviations of asset prices from fundamentals. Raising the policy rate also impacts economic growth.

Thankfully, policymakers have other instruments at their disposal—call them cyclical regulatory tools. These include: capital ratios, to address leverage; liquidity ratios; loan-to-value ratios, to address housing prices; and margin requirements, to address stock prices.

Combining the use of monetary and regulatory tools obviously raises the issue of coordination between the monetary and the regulatory authorities. During the crisis, we learned that separation of the two can raise significant challenges not only for identifying incipient risks, but also for handling crisis situations. We need only think of the example of Northern Rock to understand that this is an important policy question.

We have also been reminded of the critical role played by central banks as lenders of last resort, and that they must play this role flexibly. During the crisis, central banks extended their liquidity support to non-deposit-taking institutions and intervened in a broad range of asset markets. This was essential for reestablishing market liquidity.

Such liquidity provision could also play a helpful role in normal times, by stabilizing financial markets facing liquidity pressures. But such an increase in the financial safety net would need to go hand in hand with an expansion of the regulatory umbrella.

Let me address one final point on monetary policy, namely whether targeting higher inflation could leave more room to lower interest rates in the face of a deflationary recession. This idea was floated recently by Olivier Blanchard, my good friend and colleague at the IMF. I think this is an interesting idea that merits serious discussion. But it is not the principal question for monetary policy, and should not distract us from more important concerns.

Let me also be clear: we remain an institution that believes that low and stable inflation delivers positive benefits for growth and macroeconomic stability. That remains the IMF’s key message on inflation.

And I know that Olivier was not calling for higher inflation to reduce the real value of public debt. There is an important difference between a slightly higher inflation rate in the steady state, and an unexpected inflationary shock. The first should be the subject of careful economic research. The second, however, would mean inflating away the value of debt, and should be dismissed on those grounds.

Fiscal Policy

Let me turn now to the lessons for fiscal policy.

The crisis has placed countercyclical fiscal policy back at center stage. With monetary policy having reached its limits, a fiscal response was essential to tackle the downturn. In addition, because it was evident that the recession would last a long time, fiscal stimulus could have a powerful impact, despite implementation lags. Here, I am proud to say that the Fund played a pivotal role in its early call for a sizeable global fiscal stimulus.

A key lesson from the crisis is therefore that building up fiscal space in good times is very important, to allow sufficient space for fiscal stimulus in crisis times. What does this mean for fiscal adjustment in the period ahead?

Unfortunately, the required adjustment is formidable. Public debt in the advanced economies is forecast to rise by about 35 percentage points on average, to about 110 percent of GDP in 2014. Reversing this increase will be a tremendous challenge—let alone reducing debt below pre-crisis levels, which may be needed to leave enough fiscal space to tackle future crises.

Therefore, for the next decade or two, cyclical upswings should be used to reduce public debt, rather than finance expenditure increases or tax cuts. Of course, this is not a new message—but it has taken on increased importance in the wake of the crisis. Medium-term fiscal frameworks, credible commitments to reducing debt-to-GDP ratios, fiscal rules (with escape clauses for recessions), and transparent fiscal data can all help in this regard.

The crisis has also reminded us that discretionary fiscal measures typically come too late to fight a standard recession. How could automatic stabilizers be improved?

One idea would be to let certain taxes or transfers be triggered when a threshold value for a particular macroeconomic variable—such as GDP growth—is crossed. For example, to support spending by low-income households, governments could activate temporary measures such as a flat, refundable tax rebate, or a percentage reduction in a taxpayer's liability. And to support investment by firms, cyclical investment tax credits might help. Similarly, on the expenditure side, one can think of temporary transfers targeted at low-income or liquidity-constrained households.

International Policy Cooperation

Let me turn now to a third key lesson of the crisis, namely the critical importance of international policy cooperation.

As the crisis unfolded, it quickly became apparent that another Great Depression would only be averted by rapid and concerted policy action. Thankfully, policymakers around the world pulled together to respond to this profound economic—and potentially human—calamity. They took a range of bold actions—easing monetary conditions, adopting a fiscal stimulus, and cooperating on cross-border financial problems. The IMF also contributed to the international crisis response, ramping up lending to unprecedented levels.

In the post-crisis era, international policy cooperation will be even more important to secure stable, strong, and balanced economic growth.

I recently spoke about this in the context of Europe, where a broader framework of policy cooperation—encompassing monetary, fiscal, financial, and structural issues—is needed to bolster economic growth. But something similar is also needed on the global scale, to secure growth that is balanced, and hence sustainable.

In the years leading up to the crisis, significant imbalances in countries' current account positions posed significant risks of unraveling in a destabilizing way. And while imbalances have declined somewhat since the crisis, they are likely to widen again unless policies are adopted to support the emergence of new sources of growth.

The G-20's Mutual Assessment Process is an important initiative towards addressing this issue. Through this framework, the world's largest economies are accountable to each other—at the highest political level—for the global consistency of their budget, monetary and structural policies. The IMF is lending analytical support to this important effort, with an initial report on the MAP due to the G-20 later this month.

Greater international cooperation is also needed to secure serious and lasting reform in the financial sector.

At the country level, the priorities for reform are well-known. They include widening the regulatory perimeter, beefing up supervision, and strengthening crisis resolution mechanisms. In addition, financial institutions should hold more and better quality capital, and improve their liquidity management and buffers.

But many countries are approaching these big-picture reforms from different directions and at different speeds. This presents a great risk of uncoordinated policies, distorted capital flows and regulatory arbitrage.

Another major challenge is how to handle the large complex financial institutions that dominate global finance. Recent proposals for "special resolution authority" and "living wills" to handle the failure of such institutions at the parent level are very important. But the reach of these mechanisms does not always extend beyond the national borders. For this reason, I recently called for the creation of a European Resolution Authority. But a solution is also needed on a much broader international scale.

Then there is the question of whether to tax the financial sector. Here too an international approach can help find solutions that prevent the emergence of major inconsistencies across countries.

The G-20 has asked the IMF to see how the financial sector could make "a fair and substantial" contribution to paying for government interventions to repair the banking system. We are reviewing the range of options, and seek to address concerns about systemic risk and burden sharing. We also aim to take into account that this is a business activity that is riskier than others, and with costs that may spill over to taxpayers. And we are taking a broad perspective on this issue, including the trade-offs between taxes and regulation. Our preliminary report should be presented to the G-20 at the Spring Meetings later this month.

One last point I'd like to make relates to the need for better crisis financing instruments—something that the IMF is uniquely placed to provide.

Fast-paced and hard-hitting financial crises can lead to an extraordinarily large demand for official resources—in some countries, to address homegrown balance of payments problems; in others, to deal with global liquidity shortages.

During the crisis, we introduced the Flexible Credit Line—or FCL—a contingent financing instrument for countries with a solid policy track record. A number of major emerging market economies have used the FCL—in fact Mexico just renewed it—and have benefited from its stabilizing influence on financial markets. Now, we are assessing whether the FCL—and our other financing instruments—could be refined further, to meet the needs of our members more effectively.

Concluding thoughts

In drawing the lessons of the financial crisis, I see two important constants.

First, we can count on the fact that the crises of tomorrow are unlikely to be a repeat of the crises of yesterday. This means that we must remain ever vigilant to the emergence of new vulnerabilities, and not underestimate their power to unleash costly crises.

And second, as the global economy becomes ever more interconnected, the role of international policy cooperation in preventing crises—and tackling them, when they do occur—will continue to grow.

In many ways, the crisis has validated the original mandate of the IMF—cast in the final days of World War II—to foster cooperation amongst nations in the interest of global economic stability, prosperity, and ultimately of peace.

In this vein, I wish to acknowledge the tremendous contribution made by John Maynard Keynes, one of the IMF's founding fathers. I we think back one hundred years ago, we can imagine Keynes, then a young fellow here at King's, dining in this very same hall. His mind was probably focused primarily on economic theory at this early stage of his career—the Great War, the Great Depression, and World War II, which influenced so much of his specific policy ideas, still lay ahead of him.

And yet, Keynes' belief in the potential of economic policy, and its power to improve people's lives, had surely already taken firm root. Let us draw inspiration from this belief—and work together in a new spirit of global cooperation, to foster economic growth that is strong, stable, and sustainable. This is what is needed to secure our well-being—this is what we must strive for.

Thank you for your kind attention.