A Balanced Debate About Reforming Macroeconomics

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Guest post by Joseph E. Stiglitz, Columbia University, and co-host of the Conference on *Macro and Growth Policies in the Wake of the Crisis*

The most remarkable aspect of the recent conference at the IMF was the broad consensus that the macroeconomic models that had been relied upon in the past and had informed major aspects of monetary and macro-policy had failed. They failed to predict the crisis; standard models even said bubbles couldn't exist—markets were efficient. Even after the bubble broke, they said the effects would be contained. Even after it was clear that the effects were not "contained," they provided limited guidance on how the economy should respond. Maintaining low and stable inflation did not ensure real economic stability. The crisis was "man-made." While in standard models, shocks were exogenous, here, they were endogenous.

There was even remarkable consensus about many elements of policy in responding to the crisis: fiscal policy can work; we need to be wary of empirical studies based on circumstances markedly different from the current situation (where households are overleveraged, where interest rates have reached the zero lower bound, etc.).

There were large areas of consensus for the longer run: central banks will focus on more than just inflation, especially financial stability; but there will be a real challenge in developing an integrated approach.

[youtube=http://www.youtube.com/watch?v=kh6EHP7g-Mg]

The ultimate objective of a central bank is to stabilize the real economy, and financial and price stability both need to be seen as instruments toward this and other ultimate objectives. In achieving real stability, much stronger financial regulation will be required—both because of agency issues and the pervasiveness of externalities, self-regulation cannot be relied upon. Real stability will require a full range of tools for capital account management, including cross-border regulations on capital flows.

While the crisis has brought into focus the inadequacies of the standard macroeconomic models and the policy tenets that were derived from them, not surprisingly other aspects of conventional wisdom, related to growth, were also discussed. Again, there was a surprising consensus that industrial policies have played an important role in enhancing growth (though other policies, like "rule of law" and macroeconomic stability are also important). The discussion went well beyond the tired critique of "picking winners" to a more insightful analysis, based on the well-known and documented externalities associated with learning and development, instances in which markets on their own do not necessarily work well.

Perhaps the major failing of some of the earlier models was that, while the attempt to incorporate micro-foundations was laudable, it was important that they be the right micro-foundations. **This crisis, like so many earlier crises, was a credit crisis; but few of the macroeconomic models modeled credit**; neither banks (perhaps particularly surprising in models used by central banks) nor securitization was typically incorporated into the analysis. While in normal times, credit and money may be highly correlated, this is not so in the usual times surrounding crises, which is when we need to turn to

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models for guidance. Fortunately, there has been a great deal of modeling of banks and credit creation; the task ahead is to incorporate the insights of these models into the kinds of macro-models being used by policymakers.

In any meeting such as this, it's worth noting what was not discussed, or only mentioned briefly. The fact that **countries with central banks that were not independent performed so much better than some of those that were**—partly because the latter were "cognitively captured" by the financial markets that they were supposed to regulate—should perhaps lead to rethinking of doctrines concerning central bank independence. **Standard models not only don't provide a good explanation of the origins of a crisis, such as the one Europe and America are experiencing, they also don't adequately explain the slowness of the recovery.** After all, the human and physical assets that existed before the crisis are still here; indeed, in a real sense, having corrected the distortions associated with the crisis, output should be higher. Yet, for years, output has remained substantially below its potential. And it's even the case for the United States, which long prided itself on having flexible labor markets.

Many of those who had been advocates of the old policies, while seeing their limits, cautioned about letting the pendulum swing too far to the other side: inflation had been a serious problem in the past, so in

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focusing on other variables, it was important not to lose sight of the risks which high and variable inflation can impose; self-regulation clearly failed, but it can still be part of an overall regulatory scheme; capital flows bring benefits, and these should not be lost sight of.

In short, the conference made an important contribution in invigorating a balanced debate about reforming macroeconomics.

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