GLOBAL FINANCIAL CRISIS AND ECONOMIC POLICY

Monetary policy is likely to move from simple consumer inflation targeting to the additional explicit targeting of asset prices, and thereby financial stability

ILLUSTRATION BY AJAY MOHANTY

ALOK SHEEL

The macro-economic response to the recent crisis is tempered by lessons learnt from the Great Depression, and the use of policy tools following the shift from the gold standard to the free-float Bretton Woods system. Consequently, central banks and governments have by and large eschewed the cardinal sins, such as contractionary monetary and fiscal policies, and the kind of extreme protectionism embodied in the infamous Smoot-Hawley tariffs of the 1930s, that culminated in the Great Depression. It would be well to consider what is at stake. The economic and social disruption caused by the Great Depression facilitated the rise of fascism in Europe and culminated in war. While President Roosevelt's New Deal partly helped, fiscal stimulus was counterbalanced by concerns over mounting deficits. It was the destructive fiscal stimulus provided by World War II — the war economy — that finally put growth back on track.

Theoretically, Keynesian demand management policies should not be overly inflationary, since fiscal expansion merely substitutes for the contraction in private demand. In practice, governments tried to push the envelope and over-stimulate the economy, and central banks, no longer constrained by the gold standard, accommodated the expansion through issue of fiat currency (monetising the deficit), making fiscal policies inflationary. The *reductio ad absurdum* was reached in the 1970s, following the oil price hike, when fiscal policies failed to adjust appropriately, leading to hyper-inflation even as growth remained below trend ('stagflation'), destabilising the widely acclaimed Phillips curve trade-off between growth and inflation.

Milton Friedman and the Chicago School sounded the death knell of Keynesian economics by placing monetary policy at the heart of macro-economic policy. It was Paul Volcker's monetarism that finally slew the dragon of hyper-inflation. Over time, monetary policy tools have become rule-bound. The US Fed has by and large followed the Taylor Rule, adjusting short-term interest rates to attain targeted inflation and trend growth.

There are, however, limits to the use of rule-based monetary policy, since interest rates cannot dip below zero. These limits are breached as inflation rates drop and the output gap grows, and there is little demand for money even when the central bank discount rates are zero-bound. This is the liquidity trap, into which Japan fell in the 1990s, and arguably the US in the wake of the recent global financial crisis. Ben Bernanke, current chairman of the US Fed, and a historian of the Great Depression, postulated that in these circumstances central banks are constrained to resort to unconventional monetary policy, expanding money supply not only through its discount window, but also through purchase of government (quantitative easing) and/or private (credit easing) assets, giving him the epithet of 'Helicopter Ben', as this is tantamount to dropping money by helicopter.

In a true liquidity trap, however, neither conventional nor unconventional monetary policy works, as monetary policy transmission channels break down altogether. In these circumstances macro-economic policy is constrained to fall back on fiscal policy, as in Japan since the nineties, and in the United States and much of the developed world currently, to pull the economy out of crisis.

Accelerated globalisation has also queered the pitch for both monetary and fiscal policies, since their national scope is blunted by cross-border spillovers through financial and trading channels. Alan Greenspan, erstwhile chairman of the US Fed, famously remarked that the Fed was losing control of long-term interest rates. To a great extent this surge in cross-border flows is associated with exchange rate interventions on an epic scale, in what has come to be called 'Bretton Woods II', and consequential build-up of global imbalances. Global integration makes monetary policy impact the price of domestic asset markets much more than traded goods and services that comprise consumer price indices targeted by central banks. Thus loose monetary policy in the US in the run-up to the crisis led to asset price inflation, even as consumer prices remained stable. Fiscal policies also leak abroad and are less effective in stimulating domestic demand.

It is difficult at this point in time, with little benefit of hindsight, to determine whether we are passing through yet another financial crisis that has punctuated economic history from time to time, or that globalising forces have forced a historic tipping point that will change macro-economic policy in fundamental ways.

Firstly, the severity of the recent financial crisis is at least in part due to the fact that macro-economic policy did not adjust to globalisation. Recognising this blunting of macro-economic policy tools, the G-20 has been co-ordinating policies of systemically important economies, to make them more effective.

Secondly, the crisis has underscored the limits of monetary policy, and endowed fiscal policy with the new-found halo of macro-economic tool of last resort. If aggressive fiscal policy can put the economy back on the path to sustainable growth quickly enough, it can be practically self-funded through the rise in revenue. Conventional wisdom on the efficacy of fiscal policy is however discouraging, for it has worked only where it was timely, temporary and targeted. Political economy considerations make such a happy confluence challenging. A protracted recession moreover queers the pitch for fiscal policy through a rapid and unsustainable rise in public debt, leading to a 'Domar' debt trap. In such an event governments may have no alternative but to inflate their way out.

Japan was able to fund persistent deficits that has seen public debt rise to twice its GDP, since public dis-saving was offset by private savings through large current account surpluses. This would not have been possible in a globally synchronised downturn, such as what prevails presently. US deficits on the other hand have access to the glut in overseas savings as issuer of the global reserve currency. Other countries follow the unique Japanese and US models at their own peril.

Thirdly, although the origin of modern central banking — certainly of the US Federal system — was primarily in response to financial panics and instability in the opening decades of the twentieth century, this has over the years been overlaid by the imperative to stabilise growth. The recent global financial crisis has however drawn attention back to the original mandate of central banks. Consequently, while remaining the first line of defense in stabilising growth, monetary policy is likely to move from simple consumer inflation targeting to also explicitly target asset prices, and thereby financial stability. Since short-term interest rates may be too blunt an instrument for targeting asset prices, additional instruments may be necessary. Arguably, monetary policy could have two separate targets and instruments: targeting liquidity through short-term interest rates, and targeting financial instability induced by hyper-leverage through regulation.

The author is a civil servant. Views are personal