

# Future policy direction

The IMF's financial crisis post-mortem has started



As the dust settles on the global recession and the industrialised economies treasure their first quarters of recovery, the IMF has offered some bold suggestions on the future of economic policy. Or rather, some economists at the IMF, whose views should not be attributed to the IMF.

It seems that the model of monetary control has come to dominate policy in the advanced economies - an independent central bank setting interest rates to achieve a targeted rate - has had its day.

The one instrument/one target approach thought sufficient to maintain a small and stable output gap with low inflation. Fiscal policy was relegated to a supporting role while financial regulation lay outside the macroeconomic policy sphere.

## [Inflation targeting could not do it all](#)

The change in heart is the result of doubts over a couple of key assumptions behind the inflation targeting model. The first is that the real effects on the economy of monetary policy came through interest rates and asset prices, not through control of any monetary aggregates.

The second assumption is that all interest rates and asset prices are linked through arbitrage. This would allow long term interest rates to be the weighted average of risk-adjusted future short rates and asset prices to be the risk-adjusted present discounted value of payments on the asset.

All other interest rates and asset prices would be led by current and future expected short term interest rates.

But in the years preceding the financial crisis, some asset prices and credit aggregates became unmanageable and required macroeconomic adjustments to correct. In some economies there appeared to be a trade-off between low inflation and a stable output gap.

And the low interest rates facilitated low inflation limited the policy response to the crisis. Most central banks adopted (close to) zero policy interest rates. They would like to have gone further but were prevented by the zero nominal interest rate bound.

This limit to monetary policy drew attention to fiscal policy. It helped that the recession was expected to be long-lasting, since one of the main flaws in fiscal policy is that its effects are a while. The limit to fiscal policy has turned out to be the amount of debt the state has already taken on.

### So multiples might be the answer

The IMF economists, whose views should not be attributed to the IMF, conclude that the era of simple inflation targeting is over. Macroeconomic policy must have multiple targets.

Fortunately, there are multiple policy instruments which can be used across monetary, fiscal and regulatory management.

### Higher inflation targets

The IMF economists consider increasing inflation targets, from the customary 2% to 4%. This would create more space for interest rate reductions when needed and reduce the likelihood of deflation.

This benefit would come with the costs. These are the distortions of higher inflation and structural changes to the economy (such as wider wage indexation) which magnify the effects of economic shocks on

the inflation rate and reduce the effectiveness of policy action when taken.

The IMF economists consider combining monetary and regulatory policy as a way of incorporating asset prices into interest rate decisions. Cyclical regulatory rules could be used to manage liquidity if ratios or house prices appeared to be too high or too low.

### More policy complexity

This added complexity to the conduct of monetary policy could reduce accountability for the maker. And in the UK, this would mean combining the Bank of England with the Financial Services Authority.

The IMF economists also support the continued use of liquidity support to non-deposit-taking institutions when the crisis has passed, accepting the moral hazard involved and the consequences of transferring private sector risk into the government balance sheet.

They also, perhaps predictably, make the case for more 'fiscal space', keeping government debt levels low to leave greater scope for deficit spending in times of crisis.

A final plea is made for better automatic fiscal stabilisers. More acute fiscal drag during

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periods of high economic growth or temporary tax policies triggered by a macroeconomic variable crossing a threshold are suggested.

### Viewpoint

Collectively these recommendations are extremely challenging. They require a fundamental change in the public purpose of fiscal policy if the maintenance of 'fiscal space' is to become a feature of the advanced economies.

Moreover, the current fiscal plans of the major industrialised economies would seem to put the prospect of better fiscal stabilisers into the latter half of the 2010s at the earliest. But the IMF economists are absolutely correct in diagnosing that the financial crisis was not caused by macroeconomic policy.

The flaws exposed in the (pre-crisis) policy framework suggest that the one instrument/one target approach does need to be supplemented by a more complex targeting arrangement.

However, no model exists which might offer guidance to achieving optimal multiple-target policy arrangement. It looks as though first century macroeconomic policy development will be by trial and error, much like the previous centuries. ©

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