

A Transatlantic Lesson: the Role for Activist Rules

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*Dealing with the crisis: comparison of policies
and approaches in the US and EU*

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A Transatlantic Lesson: the Role for Activist Rules

1. Discipline is distinct from doing little
2. Counter-cyclicalities is the key
3. Monetary policy should lean against the cycle, not the wind
4. Fiscal policy should be automatic
5. Financial policy should limit behaviors
6. US policy needs more rules, and the EU needs more activism in its rules

Discipline is distinct from doing little

- In transatlantic discussion, the US is oft portrayed as spendthrift, impatient, short-term – *undisciplined*, for short
- The US *is* undisciplined on macro policy, but in the sense of being ad hoc and discretionary in policymaking
- The EU can teach the US about *constraining policymakers*, but that *does not require reactive policies*

Counter-cyclicalities are key



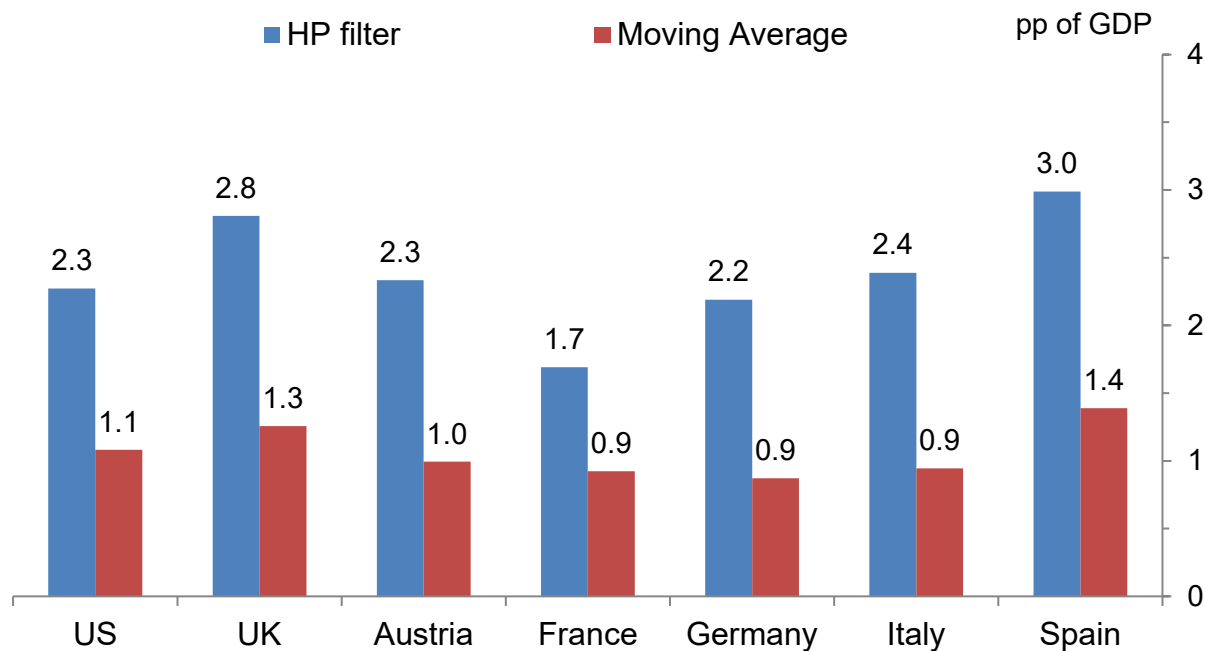
- The first step is deciding what is structural versus cyclical in nature
- This is difficult, but it is not completely arbitrary, and it must be done anyway
- It is no more virtuous to underestimate potential than to overestimate it
 - Underestimation may do greater harm
- The US bias towards supply-side optimism is excessive, but the EU bias towards pessimism is worse

Estimated Decline in Trend Output Growth Post-Crisis



	HP	MA
Mean	2.4	1.1
SD	0.4	0.2

Estimated decline in trend output growth post-crisis



Sources: OECD Economic Outlook, Statistics Austria and Bank calculations

Note: Calculated as the decline in the growth rate of HP filter trend and 10-year moving average of real GDP between 2008 Q2 and 2010 Q2

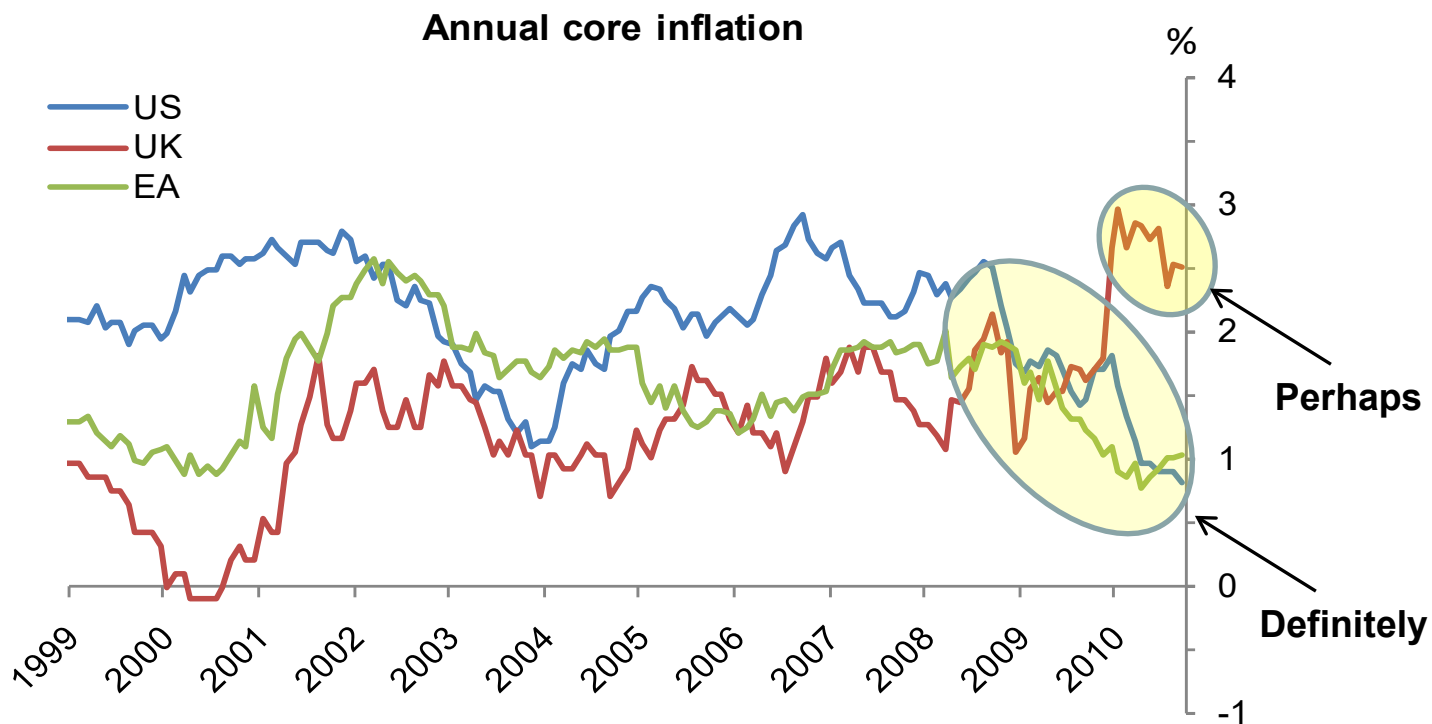
Counter-cyclicality is key

- Mechanical estimations are misleading
 - So similar Germany and US? No
 - Have to *interpret* latest data
- Large rapid shifts – up or down - in potential should generally be doubted
 - Large drops in *aggregate supply* can occur, but need a proximate cause
- The risk is from limiting action in response to large shocks and from defining deviancy down

Monetary policy should lean against the cycle, not the wind

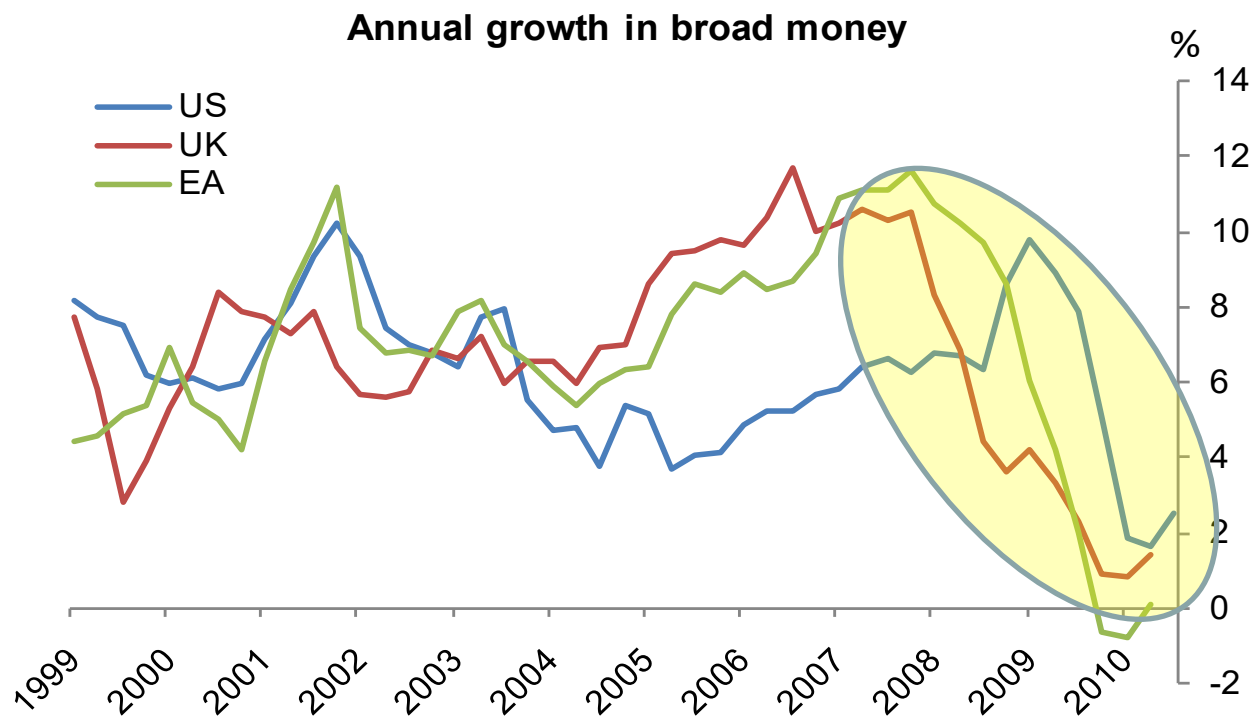
- US/ECB/UK monetary policy very similar pre-crisis and in crisis response
- Since then, inflation targeting led to disciplined discretion
 - Absent an explicit target, the Fed has let disinflationary pressures build too far
 - With a pair of targets, the ECB has been able to dodge meeting either one
 - The BoE's target means we have to *justify* forward-looking policymaking

Core Inflation – when it trends, central banks should move



Sources: Eurostat and the Bureau of Labour Statistics

Broad Money Growth – If you want to take this seriously, please do so



Sources: Bank of England, Federal Reserve and ECB

Monetary policy should lean against the cycle, not the wind

- All the talk about leaning against asset price movements is just hot air
 - No empirical basis, no examples of success
 - Watch the emerging markets now show how open economies trying this will fail
- Judging output gaps and potential is far more important and feasible than evaluating the existence of bubbles
- Too many indicators give central banks excuses for inaction or dithering

Fiscal policy should be automatic

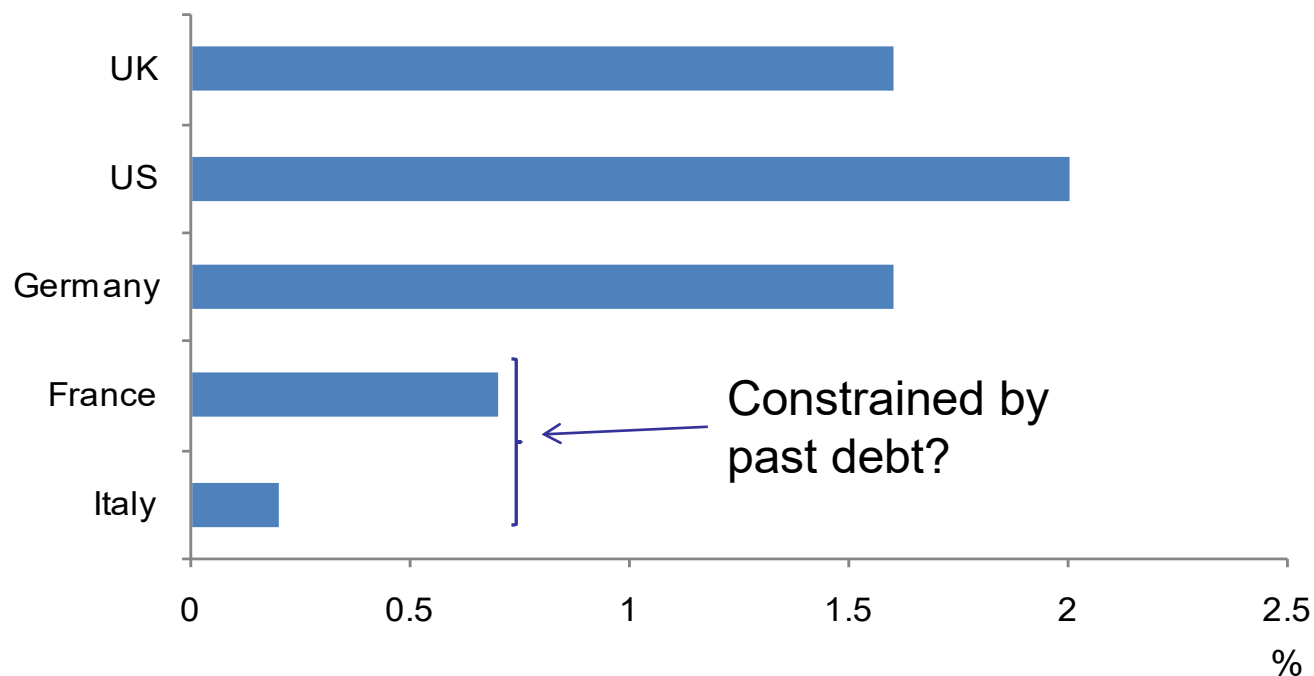
- Lots of talk now about fiscal rules
- Proposals either focus on one side (consolidation) or long-term only
- Getting the form and credibility of stimulus right is just as important
- If more automated, de facto more coordinated and less leakage
- If more automated, less uncertainty for either markets or households

Discretionary Fiscal Stimulus – How much by whom?



NOT driven by rise in unemployment alone or by size of state

2009 discretionary stimulus as a percentage of GDP



Source: IMF (Horton et. Al. 2009) and Bank calculations

How much did budgetary conditions erode since the crisis?



But discretionary policy is *less than one-sixth of total* budget erosion

	UK			US			Germany			France		
	2007	2010 ^(c)	Change	2007	2010 ^(c)	Change	2007	2010 ^(c)	Change	2007	2010 ^(c)	Change
Gross public debt ^(a)	43.9	76.7	32.7	62.1	92.7	30.6	64.9	75.3	10.4	63.8	84.2	20.4
Net public debt ^(a)	38.2	68.8	30.7	42.4	65.8	23.4	50.1	58.7	8.6	54.1	74.5	20.4
Budgetary Balance ^(b)	-2.7	-10.2	-7.5	-2.7	-11.1	-8.4	0.2	-4.5	-4.7	-2.7	-8.0	-5.3
Total outlays ^(a)	40.3	46.6	6.3	36.6	41.4	4.8	43.6	46.5	3.0	52.3	56.3	4.0
	Spain			Italy			Austria					
	2007	2010 ^(c)	Change	2007	2010 ^(c)	Change	2007	2010 ^(c)	Change	2007	2010 ^(c)	Change
Gross public debt ^(a)	36.1	63.5	27.3	103.5	118.4	14.9	59.2	70.0	10.8			
Net public debt ^(a)	26.5	54.1	27.6	87.2	99.0	11.8	48.7	59.9	11.2			
Budgetary Balance ^(b)	1.9	-9.3	-11.2	-1.5	-5.1	-3.6	-0.5	-4.8	-4.3			
Total outlays ^(a)	39.2	45.6	6.4	47.9	51.2	3.3	48.8	52.3	3.5			

(a) Percentage of nominal GDP.

(b) Surplus or deficit as a percentage of nominal GDP.

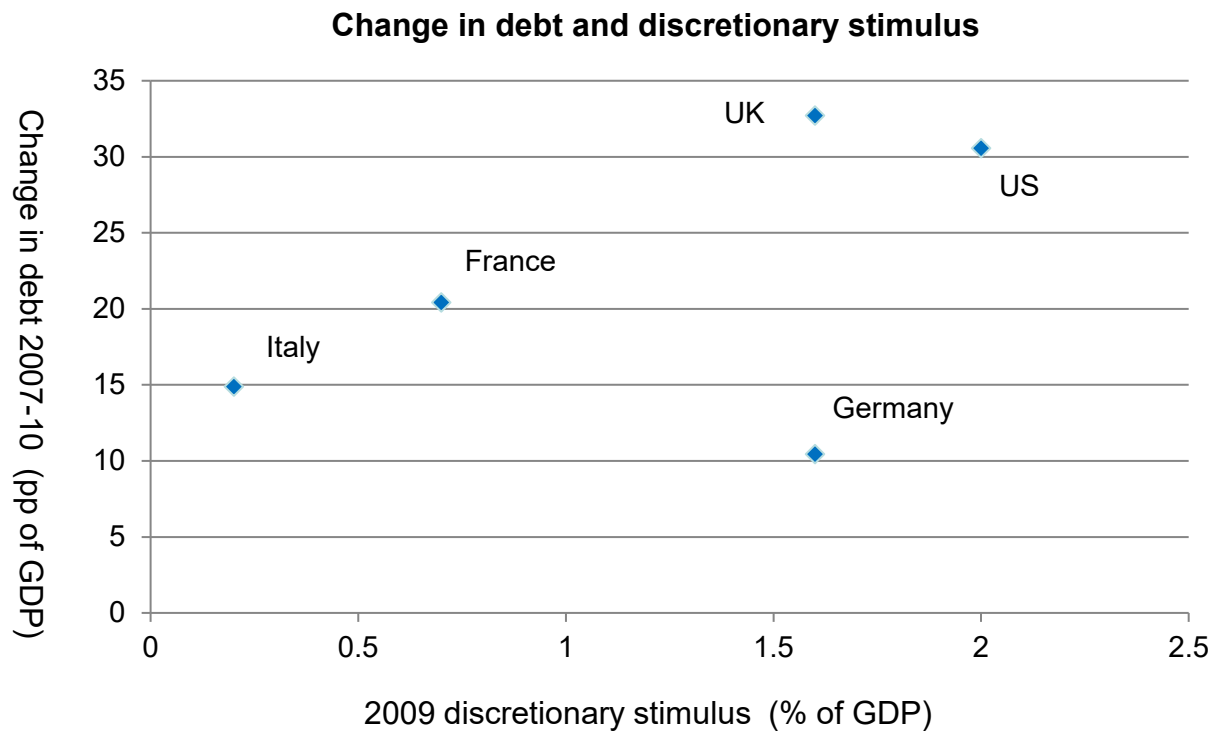
(c) 2010 is forecast from the October 2010 WEO.

Source: IMF World Economic Outlook

Discretionary Fiscal Stimulus and Change in Debt Level



Those who had more room to start did more stimulus



Source: IMF (Horton et. Al. 2009) , IMF WEO and Bank calculations

Fiscal policy should be automatic



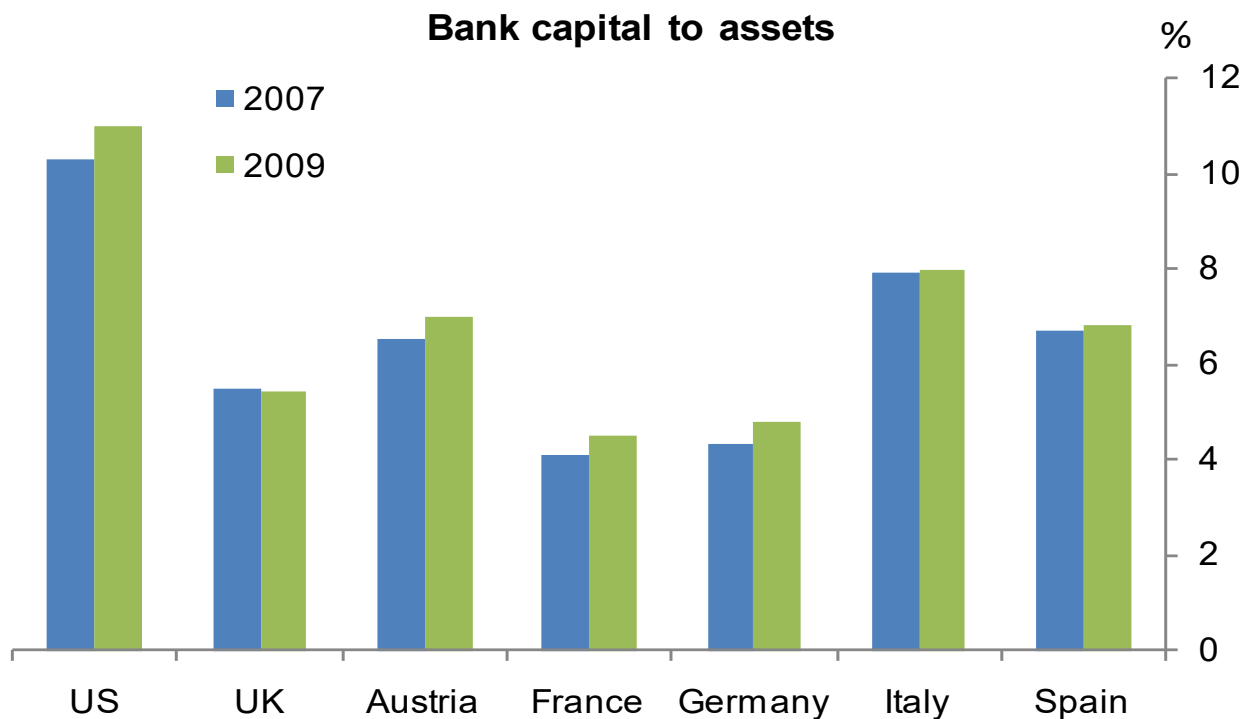
- So there is a lot more room for good automatic stabilizers than what arose accidentally from past welfare states
 - Cyclical real estate taxes, VAT...
- The sub-federal limitations – particularly in the US states, but also within EU – add a harmful pro-cyclical offset, as do debates over unemployment benefits
- Deterring ‘bad’ fiscal behavior is not the same as designing a better system

Financial policy should limit behaviors



- The emphasis to date has been on tweaking incentives of current financial institutions and building capital buffers
- But that doesn't confront the problem:
 - Global across types of banks and regs
 - Capture of regulators by bankers
 - Government guarantees implicit but real
 - Too big to fail (*not* “too systemic tf”)
 - Mistaken consumer perceptions

What do capital asset ratios tell us? We're back to where we started?

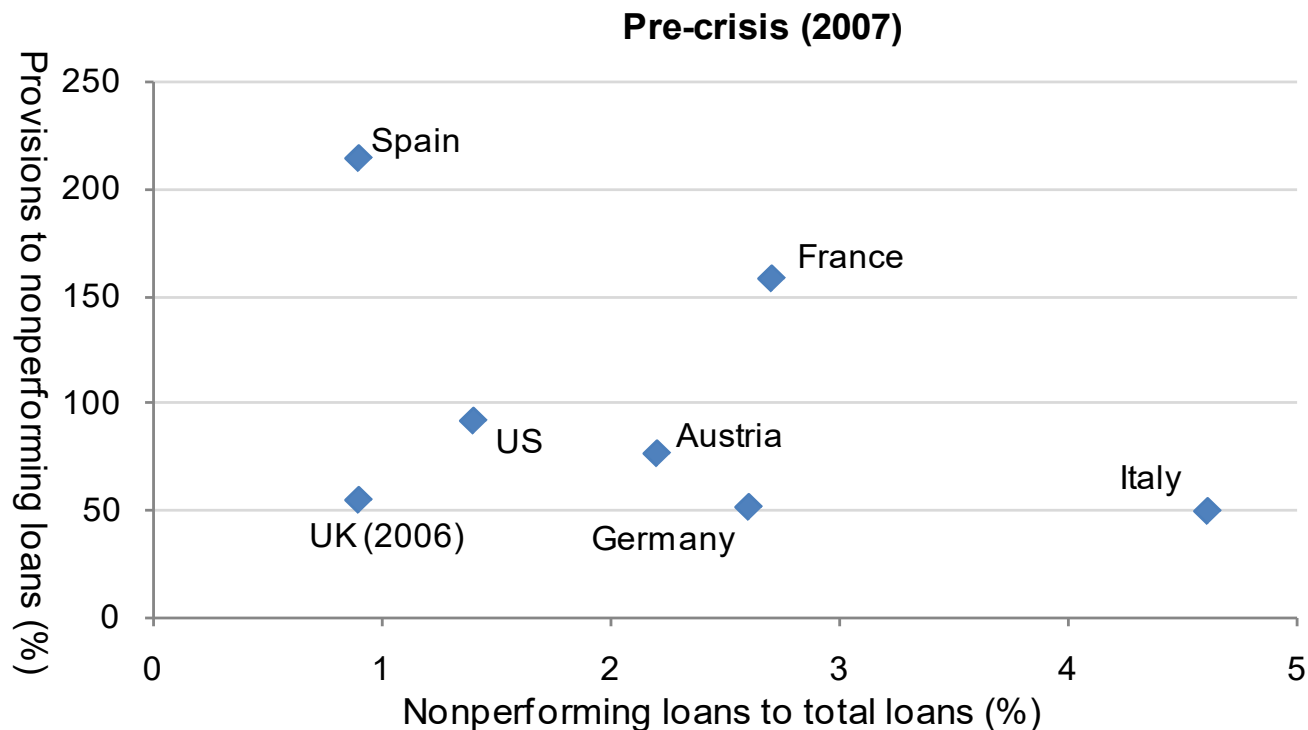


Sources: National Authorities and IMF Staff Estimates

Where were the non-performing loans pre-crisis?



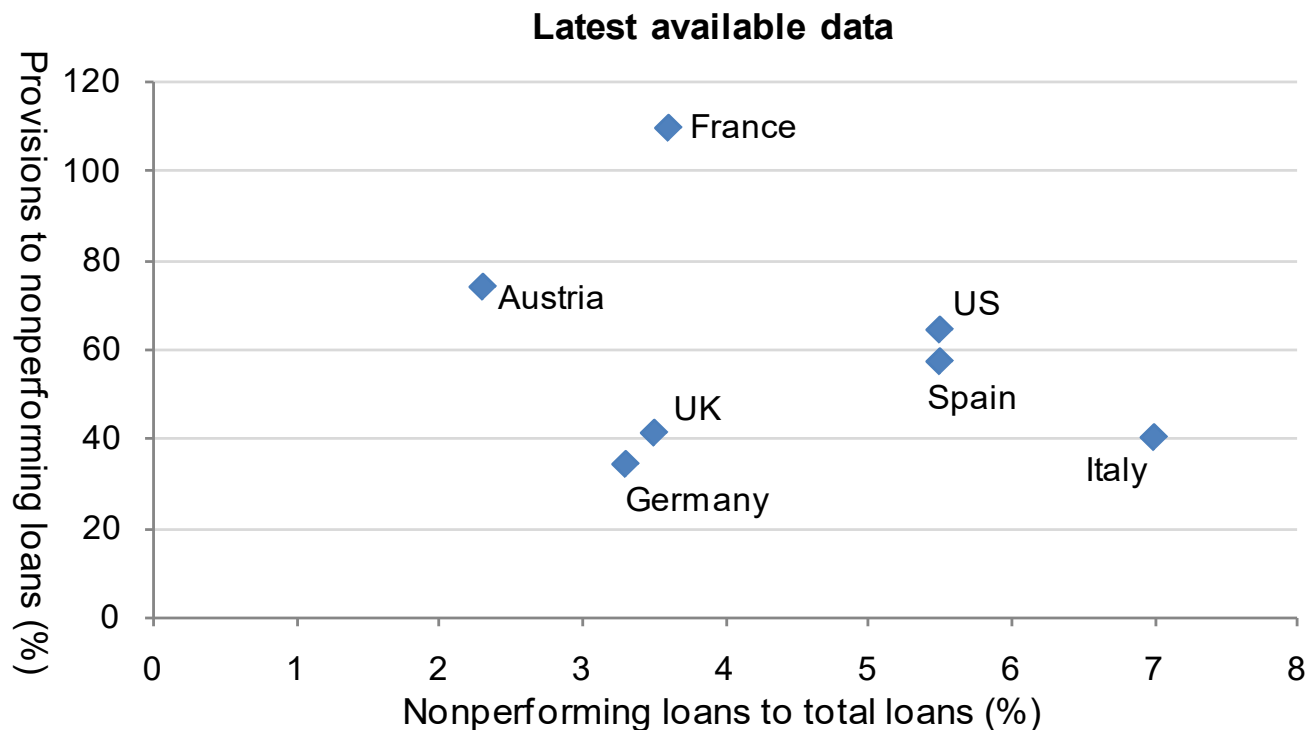
Spain, UK, and US looked pretty good going into the crisis



Sources: National Authorities and IMF Staff Estimates

Did that tell us anything about the non-performing loans post crisis?

No, it did not, either on extent of NPLs or on provision for them



Sources: National Authorities and IMF Staff Estimates

Financial policy should limit behaviors



- This applies as much to regulators and supervisors as to financial institutions
 - Why do we think committees will work?
 - Why should macropru be judgmental?
 - Why is the information flow any good?
 - Why won't institutions 'cheat' so long as possibility of discretionary relief exists?
 - What is the incentive for supervisors not to put off problems as they always did?
- Time for big simple blunt restrictions
 - Have regulators updating rules instead

A Transatlantic Lesson



- US needs more rules
 - Blind supply optimism and discretionary monetary policy leads to confusion
 - Fiscal federalism and ad hoc welfare state becomes worst of both worlds
- EU needs more activism in its rules
 - Supply pessimism promotes passivity
 - Fiscal and monetary rules are biased to one side instead of truly countercyclical
- Both are going wrong with financial reregulation by allowing discretion